Q1 2013 Earnings Call

Company Participants

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

Other Participants

- Hasan Doza, 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 first quarter of 2013. The audio for this conference is being broadcast simultaneously through the Internet in the website, www.sabesp.com.br. In that same address, 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 Mr. Rui Affonso, Chief Financial Officer and Investor Relations Officer; Mr. Mario Arruda Sampaio, Head of Capital Market and Investor Relations; and Mr. Marcelo Viatchi, [ph] Head of Accounting.

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

Mario Arruda Sampaio

Okay. Good morning, everybody, and thank you for participating of this conference call, once more to discuss our results. We have today a five-slide presentation to discuss the main events of the period, and after that, as mentioned, we will go to our question-and-answer session.

Let's move then to slide three, talk about our company's billed water and sewage volume that came up 2% on the first quarter to -- over first quarter 2012. This increase in billed volume was due to the increase of 2.7% in water connections and 3.5% in sewage connections. This is in line with expected growth of approximately 2.5% in billed water volume and between 3 and 3.5% in billed sewage volume, the latter influenced by the company's large investments in this segment.

The water loss ratio remained flat, closing the quarter at 25.5%, but we again, you would like to remember that last year the company signed a very unprecedented loan agreement with JICA, the Japanese official bank, totaling at BRL710 million to finance our corporate water loss reduction program. I believe we mentioned this before. Just like to highlight that we are expecting that the initiatives of the first stage of the program should take -- start to take effect in the beginning of the second half of 2013 this year as we are in the process of, final process of bidding and hiring the work services. After that, we definitely should keep track and expect reductions in our water loss ratio.

Let's move now to financial highlights, or slide four. Here we see that the net operating revenue was positively affected by the 2% upturn in total billed volume and the 5.15 tariff increase as of September 2012. Cost and expenses fell by 2.4% in the period. And if we exclude construction costs, the item cost and expenses climbed a little bit more 7.3, which, as a percentage of net revenue, again, excluding -- sorry, which as a percentage of net operating revenue excluding construction cost, this figure increased from 51.8% in first quarter of 2012 to 54.2% this last quarter. Adjusted EBITDA increased by 3.7% from 888 million in the first quarter of last year to 921 million this first quarter. The margin came to 34.8 versus 34.5 in the same period of last year. Excluding construction costs and revenues, the adjusted EBITDA margin came to 42.4% in first quarter 2013 against 43.3 last year. Net income then totaled 496.2 million, a 0.9% increase.

Let's go to slide five. Here we discuss the main variations in cost in relation to the same period of last year. Excluding construction costs, overall costs climbed 7.3% year-over-year due to the increase of 45.5% in treatment supplies, 28.4 in general expenses, 14.6% in taxes, and 13.7% in payroll and benefits. We like to highlight the decline of 13.7% in services and 3.7% in electric power.

Now let's comment on these. First, treatment supplies, as mentioned increased 45.5%, that is a 20.3 million variation due to higher consumption of aluminum polychloride, a product that ensures water quality when we are at maximum flow which is where we are in this period of the year. Also higher consumption of activated carbon, this is due to the weather and watershed conditions, which impacts the quality of the water we produce, associated with the price also increase for these elements of 11.73%.

Also higher consumption of lime or again due to the higher treated volume and also associated with the price increase of approximately 7%. And for last, a higher consumption of iron chloride in order to meet quality parameters in the treatment of the water resulting again from the strong rain in the city of Cubatao, provides a lot of water for the metro region of Santos.

Other reasons for the increased consumption, certain supplies including the start up on new sewage pumping stations and higher chlorine consumption due to increased turbidity and color of the Guarau Treatment Station and so you know that Guarau Treatment Station is responsible for water that we provide to significant portion of the metro region of Sao Paulo. So it has a very big impact.

As for general expenses, it increased 47.6 million or 28.4% due to the provision for losses in the amount of 24.6 million, agreements for environmental compensation of 17.3 million and the provision for payment to the municipal fund pursuant to the service agreement with the municipality of Sao Paulo.

Tax expenses increased 5.1 million or 14.6% especially in the municipality of Sao Paulo due to the 5.4% increase in -- it's called the IPTU, which is an urban land municipal tax and also due to expenses related to layout and expansion of our Sao Paulo downtown business units which is a very big unit.

Payroll and benefits, big, big expense, increased by 55.5 million or 13.7% due to the 6.17 increase in wages as of May 2012 with an impact of approximately 33 million. The provision for vacation also with 4.3 million impact again the due to the increases in wages and head count in the period. Over time work pay increase of 5 million and 9.3 million upturn in the provisions for the defined benefit plan due to changes in actuarial assumptions.

Service expenses declined 36.3 million or 13.7% due to the reversal of the provision for expenses following the end of the partnership with the Sao Paulo municipal government. Electric power decreased 5.5 million or 3.7% from 150 million first quarter last year to 144.8 million this quarter mainly due to the average reduction of approximately 25.5% and the distribution system usage tariff of consumption units that are included in the free market and that is a consequence of Provisional Presidential Decree 579 and Law 12,783 which recently was enacted by the government.

But again, as you can see, the impact is not as big as we announced. We have a less of an exposure to this benefit. Unfortunately, but on the flip side some benefit we made, 3.7% reduction, but the bad side is that this is mostly non-recurring for the coming quarters.

Let's move to slide six and comment on the items that affected net income. In the first quarter of 2013, net operating revenues increased 57.3 million or 2.6% over the same period in 2012, mostly due to the 2% upturn in billed water and sewage volume associated with the 5.15 tariff increase as of September 2012.

Cost and expenses, including construction cost, increased by 44.4 million or 2.4% over the same period in 2012. Net finance expenses and revenue including monetary and exchange rate variation had a 17.7 million negative impact on the variation between the period. This variation was mostly due to, first, the lower appreciation of the reais against the dollar of 1.4% in first quarter versus 2.9% in first quarter last year and the appreciation of the reais against the yen of 10% this quarter against 9% in first quarter last year, all this leading to a 29.6 million increase in expenses.

Again, the second point is the higher monetary variation on domestic loans and financing due to the increase in total debt, our total debt following the 17th debenture issuance that occurred in February 2013 and also the 1.9% IPCA rate variation in this first quarter compared with the 1.2 variation in the same period last year, all this increasing expenses also by 15.6 million. These increases were mainly offset by the decline related to the interest on lawsuits, especially against suppliers and contractors, what reduced expenses by 25.3 million. Finally, income tax and social contribution recorded a negative variation of 2.9 million due to the higher operating result in the period.

Now let's move to our last slide on regulation. Here, we would like to discuss the recent developments of the process of implementation of SABESP. First, tariff revision by ARSESP. Going back, on April 24, we held a conference call in which we discussed these facts in greater detail. We will now quickly review the main items that were discussed in the occasion -- in that occasion for those who did not attend event as well for those who did attend, but again like to revisit the issue.

We'd like to take the opportunity to explain again that the proximity of the disclosure of the resolutions 406 and 407 from ARSESP both on March 22nd conflicted with the disclosure of our four quarter numbers on March 21. Being that the main reason for us to cancel our conference call on March 26th as at the time we felt not fully understanding of the resolutions, their impacts and application and we thought that would be the key element for the discussion and not the very good results that we came in the first quarter. So not to talk only about the fourth quarter results and not the relevant information that just came out, which we could not comment, then we canceled that conference call.

But again, in fact, couple of days before, in March 19th, that is three days before the disclosure of the preliminary maximum average tariff, we requested a 10 day postponement to allow us, SABESP, to better qualify our positions regarding CapEx and OpEx, but again our request was not granted. As a result, on April 4 with resolution for 406 already disclosed, we filed an appeal along with ARSESP with a request for reconsideration of said decision.

That means that with a request for reconsideration discussion still could progress between SABESP and ARSESP all the way up to April 22, the reference date for the application of the new tariff and in our case, the discussion and our objective was to apply immediately as many of the issues in the request as possible. Otherwise, we would have to leave that open for over 120 days, which is what ARSESP has legally established time to respond for the appeal. But again, as you already know, ARESEP made no statement regarding our request and the increase is maintained at the announced 2.35 or 9%.

Having said that, I would like to remind you of the content of Resolution 406 and 407 and subsequently Resolution 413 published on April 19. Resolution 406 approve the preliminary maximum average tariff for the first quarter for the first four year tariff cycle.

We approved the increase as mentioned, was 2.35% or 9% applied linearly to (inaudible) tariff. The resolution also approved the pass through of the regulatory fee equivalent to 0.5% of revenue from regulated municipalities and all of these represent over 95% of our total revenue and also the new formula for the annual tariff adjustment. The 2.35% increase came effective on April 22nd, while the regulation fee pass-through will be applied by SABESP as soon as we conclude the operating adjustments that are necessary to include it in the bills of the municipalities where it will be charged.

The new formula for the annual tariff adjustment replaces the previous one which had a portion A of pass through of non-manageable cost and portion B of manageable costs in which we applied the IPCA consumer price index. This formula we have been utilizing ourself since 2003 and regulator since 2008. That has been put aside, the new formula does not distinguish between manageable and non-manageable costs, that is it passes through 100% of inflation measured by IPCA and deduct from the index -- deduct from this the productivity index and the quality factor. In the latter case, it can only be important applied as the third year of the tariff cycle, to be very specific the quality factor element.

Before we revisiting Resolution 407, let's go a little bit into the main issues of our request for reconsideration. First, on the CapEx side, the company disagrees with the treatment given by the regulator to work-in-progress, as they are excluded from the regulatory asset base. We believe that ARESEP's decisions contradicts the methodology already approved by it as it now considers investment incorporated into the operation not disbursement investments as previously determined.

On the OpEx side, our main disputes refer to the exclusion of expenses with the profit sharing program and the payment of private pension in the G-0 plan where we found legal difficulties to sustain not paying and providing these benefits to employees and pension holders. And also, expenses related to credit recovery and compensation of executive officers and members of the board, which in our opinion are consistent with the common management practices of companies with the size of SABESP.

Revolution 407, let's talk about that and remember it authorizes SABESP to pass through the amounts related to municipal charges legally established in program or service agreements, contracts to the bill for those services we provide to end users. This resolution refers to more specifically the pass through to the tariff of the funds that SABESP has been transferring to the municipal fund for environmental sanitation and infrastructure since June 2007, all this pursuant to the service agreement signed with the Sao Paulo municipal government and the state and the Sao Paulo state government.

Now let's talk on Resolution 413. As we said, it was published on April 19 and suspended the effectiveness of Resolution 407 that is the pass through in such postponing the authorization for the pass through of the legal charges to the tariff to the moment of disclosure of the final results of the tariff revision, which according to ARESEP's schedule is August 9th. So it basically it suspends the application now and postpones application by August 9.

We believe this postponement was mainly, but not solely caused by the request filed by the Sao Paulo state government, which is requesting more time to carry out studies of public policies for minimizing the impact of the application of the pass through into Sao Paulo metro region, not only the steady, [ph] so note that the state government has filed was request for postponement, but that is following normal procedures of regulatory agency, thereby we understand that as we file directly to ARESEP is validating the process as a whole.

And as you know, we price first, the process being implemented, validated and finally applied. But still regarding the Sao Paulo state motion, note that the Federal Supreme Court has recently concluded the judgment of two lawsuits and granted authority in the metropolitan regarding the authority in the metropolitan region and having decided on the shared control for sanitation between the states and the cities.

That means now that the Sao Paulo state has clearly legal concession power over the metro region, thereby strengthening its position in the development and application of public policies in this area, so that we understand supports a little somewhat the reasons why it requested that postponement in our view.

Last but not least, we would like to mention that on April 21st just recently, we filed along with SABESP a request for postponement of the tariff structure for 12 months. As you know, it was due for us to present to ARESEP to open discussions on the tariff structure. So we filed a request for a 12-month postponement. The basic reasons for this request is the fact that we do not know that today the exact final tariff increase over which the new structure would be applied. And in such we are unable to clearly appraise the impacts over the demand of probable relative price changes in the final structure. So, we believe it's better to have the discussion once we went through the tariff revision and away from all the discussions that are ongoing from now all the way to August 9th.

Well, that concludes the initial remarks, and now we will open for questions and answers.

Questions And Answers

Operator

Thank you (Operator Instructions) Our first question is Hasan Doza from Water Asset. Please go ahead.

Q - Hasan Doza {BIO 17222230 <GO>}

Hey, good morning. Mario, how are you?

A - Mario Arruda Sampaio

Fine, Hasan. How are you?

Q - Hasan Doza {BIO 17222230 <GO>}

Good, thank you. I just had a quick question on the last point you mentioned which is this request for postponement, the 12 month postponement. Can you just explain that a little bit as to what tariff you are referring to on this 12 month postponement, please?

A - Mario Arruda Sampaio

Yeah, let's be very clear, Hasan. If you look at the tariff schedule, we had, as part of the process, also to review the tariff structure that is how we charge people in different categories and the cost for them according to their consumption. So we had to present by April 13, submit then our tariff structure proposal and that would all go into the same discussions around the final average tariff.

So we asked for postponement is only specifically and only the tariff structure proposal, sorry the tariff structure discussion, so all the rest is still undergoing. We have not filed any request for any other postponement other than this additional matter that would have been put into the entire environment for discussions we're in right now. Hopefully, I hope this clarifies.

Q - Hasan Doza {BIO 17222230 <GO>}

Okay. Thank you.

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

Well, thank you everybody. We will still today, put in our website, but now first in Portuguese, working hard on English our request that we have just announced so you can be more specific and understanding of what we have made public right now. Okay, thank you. And talk to you in a quarter or is this afternoon as we have the Portuguese call and investor event here. Good bye.

Operator

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