

## Q3 2017 Earnings Call

### Company Participants

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

## 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 of 2017. The audio for this conference is being broadcast simultaneously through the Internet on the website [www.sabesp.com.br](http://www.sabesp.com.br), and on the EngagedX platform where you can also find a 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.

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 Jerson Kelman, CEO; Rui Affonso, Chief Financial Officer and Investor Relations Officer; Mário Arruda Sampaio, Head of Capital Markets and Investor Relations; and Sylvio Xavier, Head of Costs and Tariffs; and Marcelo Miyagui, Head of Accounting.

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

### Mário Azevedo de Arruda Sampaio

Okay. Well, I think it's good morning, everybody. Thank you for attending our conference call this time to discuss our results for the third quarter of 2017 and updates that we would like to comment on the tariff revision and the creation of the holding. This would be a seven-slide presentation, and as usual, we will open for Q&A at the end.

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I'd start on slide 3. Here, we show the company's billed water and sewage volume, which was up 4.8% in the third quarter of 2017, with an increase of 5% in water and 4.6% in sewage, that is compared with the same period in 2016. On this slide, you can also see the billed water volume, which has been increasing since the third quarter of 2015 when the water situation post crisis began to improve.

Now, let's go to slide 4. Here, we will discuss quickly our financial results. Gross operating revenue increased 5.1% over the third quarter of 2016. That is due to 4.8% (03:20) upturn in total billed volume, 5% of which, as we mentioned, in water and 4.6% in sewage, and the lower recognition of estimated losses with wholesale revenue in third quarter 2017 that is in the amount of BRL 16.7 million, in this case, due to the payments received in the period, almost all from the City of Guarulhos.

Net operating revenue went down by 5.6%, this due to a decrease in construction revenues. Costs and selling, administrative and construction expenses, in this case including construction expenses, decreased by 10.5% or BRL 283.1 million in the period.

Adjusted EBITDA reached BRL 1.4 billion in third quarter 2015 (sic) [2017] (04:16). That's 8.9% higher than the BRL 1.3 million (sic) [BRL 1.3 billion] (04:22) recorded in the same period of the previous year. The adjusted EBITDA margin came to 41.2% in the third quarter of 2017 against the 35.7% in the third quarter of 2016. If we exclude construction revenues and construction costs, the adjusted EBITDA margin was 50.9% in 2017 versus 49.6% in third quarter 2016. Net income reached BRL 900.5 million compared to BRL 573.9 million in the third quarter of 2017.

Well, here, we should note that if we disregard the positive effects of the exchange rate and monetary variation and the reduction effect on income tax and social contribution, the profit for this quarter would be approximately BRL 681 million.

Let's go to the slide 5. Here, we will discuss the main variations in cost in the third quarter of 2017. In comparison with the quarter of 2016, there was a decrease of 10.5% in cost, administrative expenses, sales and cost construction. If we exclude then the construction cost, as we've seen before, costs and expenses increased by 5.9%. Cost and expenses represented 68% of net revenue in the third quarter of 2017 against 71.8% in the same period last year. The items that grew in percentage terms were salaries, payroll charges, and expansion (sic) [pension] (06:12) plan obligations that was up 113.3% and depreciation and amortization up 15.8%. It's worth noting that the 138% decrease in estimated losses with doubtful account was mainly due to the lower default rate in the period as well as a 26% decrease in general expenses, 16.9% increase (sic) [decrease] (06:41) in services, 12.7% in general materials, and 9.4% with electricity power. For a more detailed explanation of our costs, please you can refer to our press release, earnings release.

Let's move then again to slide 6. Here, we want to present the main year-on-year variations that affected our net income. (07:11) this compared with the same quarter of the previous year. As already mentioned, net income reached BRL 900.5 million. Net operating revenue decreased BRL 209.3 million or 5.6%. Costs and expenses including construction cost decreased BRL 283 million or 10.5%. Other operating revenues and

expenses were BRL 8.3 million higher. Net monetary and exchange rate variation and financial expenses had a positive variation of BRL 399.7 million mainly due to the BRL 332.4 million decrease resulting from exchange rate variations on loan and financing due to the devaluation of the dollar and the yen against the real in the third quarter of 2017, this when compared to the appreciation of these two currencies in the third quarter of 2016.

Finally, income tax and social contribution increased BRL 155.9 million. That's chiefly due to a higher taxable income tax base, mainly driven by the devaluation of the dollar and the yen, as we mentioned, against the real this quarter versus last quarter - the appreciation in the third quarter.

Let's then move to slide 7. Here, we will briefly discuss the situation of the reservoirs that supply the metro region of São Paulo, our biggest market. The month of October marks the beginning of a new hydrological year and the rainy season that will run until March, what will lead consequently to higher water inflows to the reservoirs in this period.

So, we're expecting to increase and we should increase reservoir levels during this period. So, rainfall in the 2016-2017 hydrological year that just recently ended in September was in line with historical average. The Cantareira received 91% of the expected rain; the Alto Tietê, 80%; and the Guarapiranga, 106%. With rainfall levels in line with the average, the Cantareira system, the biggest one in the metro supplying the metro, began the 2017 and 2018 hydrological year at 51.6 (09:54) of the operating volume. Just to note at the same date in 2013, the year before the water crisis, this level was at 40.3. Despite the favorable water situation then in 2013 and to increase water security, two large projects are currently under construction and will substantially increase water availability for the São Paulo Metro Region. The first, there's Aguadia Chibaiana interconnection (10:29), has more than 90% of its work already executed, and completion is expected by the end of this year.

In this case, we will add an average of 5 cubic meters per second of bulk water transfer capacity from the Jaguari dam located in the Paraíba do Sul water basin to the Atibainha dam located in the Cantareira system and in the PCJ water basin. The other important project is the new greenfield San Lorenzo (11:08) production system. In this case, we will increase treated water availability by 6.4 cubic meters per second. 80% of the work is complete and construction conclusion expected for early first quarter 2018.

Let's move now to the recent developments in SABESP's second tariff revision process. On October 6, ARSESP disclosed a Final Technical Note, the fourth technical note of this year, which takes into account the inputs submitted to the regulator after the public hearing and consultation period. The points under discussion at this stage where the preliminary tariff or as we say, the PO and the WACC.

The initial regulatory asset base was fixed at BRL 40.3 billion, but this is not the final and definitive amount. We still have the April 2018 final number. Of the BRL 6 billion assets not recognized in the first tariff revision finalized in 2014, BRL 980 million at September prices and related to the use of cast iron pipes were recognized and included in the rep. As for

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the WACC, there was a slight increase, moving from 8.6% to 8.11%. As for the preliminary tariff or the PO, as I mentioned, in the preliminary technical notes number three of 2017, to estimate the repositioning index ARSESP adopted the average tariff in effect of 3.47484 per cubic meter after analyzing the contribution received during the public consultation process including our contribution. The regulator decided to use the consumption histograms and corresponding amounts billed from July 2016 to June 2017 that were provided by us and obtaining from these information a current average tariff of 3.37255 per cubic meter that when compared to the updated PO to March 2017 prices, resulted in a repositioning index of 7.888% against the 4.365% initially estimated in the preliminary technical note.

Regarding the 7.5% transfer to the municipality of São Paulo contract, this will be addressed by SABESP at the final stage of the review in April 2017 (sic) [2018] (14:14). In short, the main points that will be defined at the second stage are a reappraisal of the methodology adopted in SABESP's first ordinary tariff revision, a diagnosis of SABESP's economic and financial and tariff situation in the cycle ended in 2017, that is including the impacts resulting from the water crisis, the contingency tariff, and the extraordinary tariff revision that was held in 2015.

Also, we will be defining the X factor. We're expecting the quality factor also to be defined and implemented, and obviously, the final number for the regulatory asset base. Also, we expect that any compensation adjustments related to the preliminary PO established at the initial stage of the second ordinary tariff revision, which was finalized last October, will be included. SABESP has been reiterating to the regulator technical positions contained in the technical note made available to them at the public hearing and which addresses, among others, the following items: average reference tariff rate used in the preliminary and final revision, first cycle exclusion to the asset base. Those are the two key (15:47).

It should also be noted that as of November 10, ARSESP's regulation fee established by State Complementary Law 1025/2007 has been added to the service bill. The fee in the amount of 0.5% of the total service charge will be highlighted in the customer's monthly bill.

Let's go to our last slide, slide 9. We would like to comment on the company's capitalization process, underlying (16:24) the reasons that led the state government and SABESP to launch such initiative. As we have reported in relevant or material facts communication, after the approval of the PAD - PAD (16:38) is the São Paulo State private partnership and privatization program and also the hiring of the IFC to advise SABESP and the state in this process. The Legislative Assembly of the state of São Paulo approved on September 15, 2017 this year, Law Number 16525 that authorize the executive branch to create a holding company whose capital will be initially formed by SABESP shares, held by the state.

In addition to exercising the control of SABESP, the holding company will be used by the state to develop activities related to basic sanitation not carried out by the company. The law also approved the possibility for the state government to sell shares of the holding, owned or to be issued by it to private investors with a long-term profile and interest in

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infrastructure, especially in sanitation, provided that it maintains the majority of the voting capital.

Another important point is the possibility of the private investor to participate in the strategic decisions in the holding company and SABESP in such a new partner profile is set (18:00), one which is more active and in addition to holding a relevant ownership interest in the holding company, is committed to the company results as much as its investment portfolio return. Another change introduced by Law 16525 (18:20) was not adequately perceived by investors is the possibility of SABESP signing a performance contract with the State of São Paulo.

Note that this is an instrument designed to treat SABESP based on its specificities, that is the only São Paulo state-owned company listed in the Brazilian stock market, Novo Mercado, and the nice (18:44) New York Stock Exchange listing and that - so we are a company that, at the same time, we do not depend on transfers of fiscal resources by the state. And in fact, on the contrary, we transfer resources to it in the form of dividend. The performance contract intends to give SABESP autonomy in the hiring, admission, and career plan of the employees. Remuneration of the directors, profit sharing, asset and fleet management, among others, will also support deepening meritocracy and aligning the interests of shareholders, managers and employees to the company's operating and financial results. In summary, this new law will allow SABESP to achieve higher levels of governance and efficiency, preserving its nature as a mixed capital company.

So, what are the central motivations for SABESP capitalization. Here, the resources available today for the company's growth now come basically from its results and from debt, this one limited by the level indebtedness that the company understands prudent. Therefore, in current context, if we want to shorten the deadline for the universalization of sanitation services in the areas we currently cover, we would have to increase margins and indebtedness. With regard to indebtedness, SABESP has limits in its ability to obtain long-term national financing from public agencies such as BNDES (20:15), and this is due to the country's fiscal situation. So, in this context the acceleration of its investments with indebtedness would imply recourse to short-term debt, three to five-year debt in very high cost, driven by CDI and inflation plus a spread in the local capital market something absolutely inadequate to finance long-term maturity investment. In addition, it's very important this action would deteriorate considerably the debt profile, will increase financial cost, and increase the liquidity and financial refinancing risks, and obviously, our rating.

On the other hand, equity raising at a time when the shareholding position of the State of São Paulo is within its legal limit - remember, the state holds 50.3% and the limit is 50% plus one. This would require the infusion of tax resources in the company. Capital is something that is currently infeasible (21:28) for the state. Thus, setting up a holding company can be a tool to do more, faster, and better. The holding creates a way to enable private capital to enter SABESP without the state losing its control and committing budgetary resources into capitalization.

Let's remember that in overcoming the water crisis, investments in sewage treatment were lengthened in order to anticipate water security projects, thus, widening the

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deadline for the universalization of services. With the possibility of having funds from private investors in shares, it will be possible to accelerate investments and shorten the period required for this purpose.

In addition, resources from capitalization, we also serve to mitigate the conflict of pursuing universalization or more profitable projects such as accelerating the renewal of already depreciated and operationally inefficient assets, incorporating technologies, and automation of ETE of sewage treatment and water treatment facilities, and opening the possibility for a more active look at new and attractive markets within the State of São Paulo. In short, the creation of the holding company, in addition to establishing a vehicle for capitalization today or tomorrow, represents the opportunity to deepen SABESP's management model by incorporating more, as I mentioned, meritocracy, aligning shareholders and managers interest, bringing higher levels of governments, and broadening the possibility of extracting and generating even more value for more operations.

But there is, however, a key element to the success of the capitalization, and that is the regulatory process and particularly, the current tariff review. In the case of the ongoing review, it is crucial that it is completed by April and that the open points of the first cycle are resolved and that the assets originated from the investments that will be financed with the resources of the capitalization are recognized and included in the regulatory asset base. Therefore, SABESP capitalization will not take place before, one, the conclusion of the rate review process is scheduled for April 2018 (24:04); second, favorable conditions in the capital market; three, in the macroeconomic and political scenario; and the perfect understanding of the capitalization process by investors and shareholders of the company.

Taking advantage of your time, we would also like to update you on the discussions with our wholesale customers. As you are aware, on August 28 of this year, we issued a material fact informing that we received the proposal from the municipality of Guarulhos that included a wholesale water supply agreement and an agreement for the payment of debt that the Guarulhos municipal sanitation company has with SABESP. These documents are in preparation and will be submitted for approval by the parties any time soon.

Regarding the municipality of Santo André, we signed a memorandum of understanding on May 11, and since then, SABESP and the city teams are working on the preparation of studies, and evaluation is aimed at equalizing the commercial relationships and debt (25:14) existing between the municipality and SABESP. As you're also aware, on October 30, we released a notice to the market in relation commenting news published in the media in which the municipality of Santo André expressed the need for more time to continue the negotiation. Here, we should note that until to-date, the work has not been completed. We're still, in other words, working on it. Well, that's basically it. We will keep you up-to-date on the progress of both negotiations. So, again, these were our comments for the quarter.

Now, let's begin the question-and-answer session. Thank you.

## Operator

As there appears to be no further questions, I'll turn the conference back to SABESP for their final remarks.

## Mário Azevedo de Arruda Sampaio

Okay, everybody. Thank you for your time. No questions now. But any questions, any time (27:25) to myself, Angela, and to the IR team, we're at your disposal and available. So, see you next quarter, and thank you for your time. Bye-bye.

## Operator

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

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