

Q4 2015 Earnings Call

Company Participants

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

Other Participants

- Michael E. Gaugler, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen. At this time, we would like to welcome everyone to SABESP's Conference Call to discuss its results for 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 find the slideshow presentation available for download.

We inform you 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 Mr. Rui Affonso, Chief Financial Officer and Investor Relations Officer; Mr. Mário Arruda Sampaio, Head of Capital Market and Investor Relations; and Mr. Marcelo Miyagui, Head of Accounting.

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

Mário Azevedo de Arruda Sampaio

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Okay. Thank you, and good afternoon, everybody. We are here for one more earnings call. We have a presentation and after the presentation, we will be available for a Q&A session.

So let's get started on slide three. We show the company's billed water and sewage volume. In 2015, billed water and sewage volume fell 6.8% from 2014 due to the lower water availability and consequently, the measures we have adopted since February 2014 to maintain a continuous supply for the population. Due to the increased water availability since October, it is worth noting that the decline in billed water and sewage volume in the fourth quarter of 2015 was significantly lower than in the same period in 2014 when there was a reduction of 8% compared with 2% in the same period in 2015. As a result of the lower water availability, there was also a strong decline in water production volume with a 13.1% reduction in 2015.

Now, moving on to slide four, here we will discuss our financial results. Net operating revenue increased 4.4% over the previous year, mainly due to the 37% increase in construction revenue and to the tariff repositioning and adjustment in December 2014 and June 2015, respectively, and also the contingency tariff. This growth was offset by increased bonus granting and a 6.8% decline in total billed volume, which we mentioned in the previous slide. Costs and selling, administrative and construction expenses fell 5.2% in the period. If we exclude the construction costs, costs and expenses declined 13.8%.

Adjusted EBITDA totaled BRL 4 billion in 2015. That is 36.2% higher than the BRL 2.9 billion recorded in 2014. The adjusted EBITDA margin came to 33.9% in 2015 against 26% last year. If we exclude the effects of construction revenue and costs, the adjusted EBITDA margin stood this 2015 - year of 2015 at 46.6% against 34.4% in 2014. Last, net income totaled BRL 536.3 million, 40.6% lower than last year.

On slide five, we will discuss the main variations in cost in relation to the same period in the previous year. Construction cost and expenses fell 5.2% compared with last year. Excluding construction costs, cost and expenses fell 13.8%, mostly due to the BRL 696 million agreement signed with the State of São Paulo government. The other items that influenced this decline were the reduction of 98.3% in credit write-offs, 35.2% in general expenses and 11.6% in general supplies and service. For further details on each of our costs, please refer to our press release already issued.

On slide six, let's move to that. Here, we show the main variations of items that affected our net income in 2015, which totaled BRL 536 million. Net operating revenue increased BRL 525.4 million or 4.7%. Cost and expenses including construction cost fell 4.4% or BRL 498 million. Other operating revenues and expenses had a positive variation of BRL 52.2 million.

Net financial expenses, monetary adjustments, and exchange variation increased BRL 1.8 billion, led by exchange losses on loans and financing due to the appreciation of the dollar and the yen against the real in 2015.

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Last, income tax and social contribution decreased BRL 320.6 million due to the reduction in taxable income between 2014 and 2015.

Let's move on to slide seven. Here, we will comment on the investments made in 2015 and divestment plan for the period of 2016 and 2020. In 2015, the investment totaled BRL 3.5 billion. In this figure, this included non-cash investments such as PPP San Lorenzo in the amount of approximately BRL 700 million. It should be noted that the forecasted amount of BRL 2.4 billion for 2015 did not include the San Lorenzo PPP and other smaller investment, all of them equally with no cash effect.

Regarding the ratio between investments in water and sewage in 2015, as we previously commented, the priority in the next two years will be expansion of water security in the metro region of São Paulo. For this reason, water investments totaled 62% of the CapEx this year, 2015.

For 2016, the forecasted investment excluding those with no cash impact as the San Lorenzo PPP is BRL 1.8 billion. This value is lower than the originally planned for this year and lower than the plan for 2015. This reduction in the forecasted value, as well as the last year lower (08:40) figure, derives from the need to adjust the total investment amount to the impact of the water crisis on company revenues and, consequently, in our cash generation.

Of the planned amount of 2016, as in 2015, approximately 65% will be allocated to water. This ratio will begin to change in 2017 when 47% of the investments will be in water, and the completion of the two major expansion projects of water security for the greater São Paulo region will occur. Just to remember, they are the Jaguari reservoir interconnection located in the Paraíba do Sul water basin with the Atibainha reservoir located in the Cantareira water basin, and also the already mentioned San Lorenzo PPP, which both will add up to 11 cubic meters of water available to the metro region.

As of 2018, investments in sewage will resume pre-crisis levels of about 65% of the CapEx. For the period between 2016 and 2020, we expect to invest BRL 12.5 billion, that is BRL 5.3 billion in water and BRL 7.2 billion in collection and treatment of sewage.

Let's move to the next slide. We have four slides, from 8 to 11, where we will analyze rainfall and water inflow into the reservoirs of the Cantareira and Alto Tietê Systems. As you will see on these slides, in this rainy season, which began in October 2015 and will last until the end of March, and is therefore it's nearing its end; rainfall and water inflow returned to their expected average for the period, allowing the reservoirs to recover. On slide 8 and 9, we can see the substantial improvement in rainfall and water inflow into the Cantareira System, which allowed us to recover the first quarter of the second reserve in December.

We would like to remind you that we started using this water quota in May in 2014. We'd also like to point out that with improvements in rainfall and water inflow since February, we obtained from ANA, or National Water Agency, and DAEE, the State of São Paulo Water Electricity Department, authorization to increase water outflow to 23 cubic meters

per second in the Cantareira System. This figure is a very substantial upturn in increase especially if we consider that in most months in 2015, water outflow was around 13 to 15 cubic meters per second.

Regarding water inflow to the Cantareira System, today the accumulated average for March is 72 cubic meters per second. We still have two days in front of us, but all this is higher than historical average for this month, which is 66.9 cubic meters per second.

Let's move on to slide 10 and 11. Here, the comment is on rainfall and water inflow into the Alto Tietê Systems, which also improved substantially. Remember that because this system is close to the Cantareira System, it was frequently used to serve the areas that used to be served by the Cantareira System alone. As in the Cantareira Systems, substantial rain volume this rainy season has been allowing it to recover.

Let's now move to slide 12. Here, we show the improvement in the situation of the reservoirs of all of them that supplied the São Paulo Metro Region in March 2016 compared with 2014. This improvement was due to two factors. The first was increased rainfall and consequently higher water inflow between October 2015 and March this year compared with the same period the year before.

The second, which was also very important, was - refers to the initiatives adopted by the company which you already know, such as granting bonuses, implementing contingency tariff and reducing pressure in the network, among others, which reduced water losses in the system and establish a better balance between supply and demand.

The combination of these factors enabled since September 2015 reservoir volumes to be higher than last year. In other words, thanks to the balance between water supply and demand in the region, the increase in water security and the beginning of the rainy seasons, which are very positive factors, we can safely say that today we are at a better structure and circumstantial situation than last year and are definitely more prepared to face 2016. With the substantial rainfall recorded in recent months, total available volume in the Greater São Paulo water supply system has exceeded the level at the beginning of the water crisis even without considering the technical reserves.

For comparison, total water available in all reservoirs in March 23 this year was close to 820 million cubic meters or 40% the same volume available in December 13, 2013. And please bear in mind that these volumes do not include the technical reserve which was used on an emergency basis. Cantareira System alone also shows figures higher than in previous years even without the technical reserves. Water volume available today in this system is equivalent to also November 2013.

On next slides, 13 and 14, we will talk about the bonus program and the main events and the contingency tariff. As you all probably know, on Thursday, last week, March 24, we sent an official letter to ARSESP requesting the cancellation of the bonus program and the contingency tariffs as of May 1, 2016. On the previous slides, we could observe that the rain falling, consequently reservoir levels were much more favorable in this rain period than in the previous two. These improved conditions combined with the conclusion and

advanced project of works (15:47) to increase water security allows us – allows for greater predictability of water source condition and water security levels in the São Paulo Metro Region.

Looking back in the measures adopted for the rational use of water during the crisis period, we prepared a graph of the reservoir levels in the Cantareira System from January 2013 to March 24, 2016 including the main events in the period. Before that, it is worth mentioning that the crisis became clear to us in 2014 after three months of record low rainfall and very low water inflow to the Cantareira System, values very close to the lowest historical levels.

As you can see in graph, the initiatives and adjustments to the bonus program and the contingency tariffs were implemented in anticipation of the need to encourage the population to adjust their consumption to water availability.

As a result, we highlight the rapid expansion of the bonus program to the entire São Paulo Metro Region, which allowed us to reduce water removal from the Cantareira System, but continue supplying the entire population with water from other systems. As the crisis showed signs that it would continue in 2015 and we had to extract water from the second technical reserve, we expanded the bonus ranges increasing the stimulus to reduce consumption. And soon after, we're authorized by ARSESP to implement the contingency tariffs with the same objective, that is reduce consumption.

With the improvement in the water situation during the rainy season in the beginning of 2015 added to our ability to reduce and stabilize the extraction of water from the reservoirs in the metro region from 71 cubic meters at the beginning of the crisis in February to around 50 cubic meters at the beginning of 2015, we were able to go through the dry season of this year, that is 2015, without compromising the water that had been accumulated during the rainy season.

As of December – as of September 2015, rainfall returned to average levels and water intake recovered to levels very close to average. All this has allowed us to change the bonus target, increasing the water savings challenged to obtain the discount, and more recently with the continuous improvement of reservoir levels, the start of an important emergency works and the fact in February 2016, for the first time, revenue obtained from the contingency tariff surpassed revenue reduction with the bonus program, we requested the cancellation of these measures to ARSESP.

Moving on then to slide 15 and 16, we will provide you with some numbers that these programs generated in terms of the population's behavior and financial impact. As you can see from 2014 to January 2016, 78.3% of the connections reduced consumption, and most of them obtained bonus. Clients who increased consumption recorded an average upturn of 21.7%. Some of those who increased consumption were not subject to the contingency tariffs either because they were eligible for social tariffs or because, although they consume more, they remain within the minimum 10 cubic meters take or pay range.

From a financial standpoint, the impact of these water demand management programs on revenue was a reduction of BRL 848 million until January 2016. The bonus alone reduced revenues by BRL 1.5 billion, figure this one that does not include price and volume effect that the consumption reduction has on the average shares and consequently on our revenue – the company's revenue.

At the end here, we can say that it has been 25 months of hard work to avoid the worst water crisis ever seen in São Paulo metro region from causing a lack of water and the need for daily rotation for the region's entire population.

Last, we would like to comment on some points. On March 30, that is tomorrow, the company will carry out a partial redemption of BRL 300 million of the 19th debenture issues with an original amount of BRL 500 million and maturing in June 2017. This partial redemption objective is to manage company total debt volume and at the same time, anticipate the amortization of debt due and in this way, reduce the pressure on refinancing volumes in the short term.

With respect to our financial covenant multiples, were all met. The total debt to EBITDA multiple which ceiling is 3.6 times and has been pressured by the reduction of EBITDA due to the extended period of the water crisis added to the steep and short-term devaluation of the real against the dollar, stood at 3.26 times. And just as a reference in third quarter 2015, this figure was 3.54 times.

On another issue, the company has also been working in the recovery of debts along with municipalities that we provide bulk water on a wholesale basis as reported in recent communication to the market. The company has signed a memorandum of understanding with the municipalities of Guarulhos, Maua and Santo André to begin studies and assessments aimed at addressing commercial and existing pending debts between the parties. In May 2015, we filed in CADIN, which is a file of unpaid credits along with the state agencies, pending debts that these municipalities hold with us to be filed. Yes. Note that all due bills and other debts are regardless of being filed at CADIN, they are also filed in courts for recovery.

In addition, in this period, the municipality of Santo André filed representation in CADIN, that's the Brazilian Antitrust Agency, alleging abuse of economic power by SABESP with sales of water to wholesale customers. After initial analysis of the allegations, CADE, that's C-A-D-E, opened an investigation. It should be noted that this is a preliminary examination phase and that there is no ongoing process. The company has been following the progress of this investigation and at the same time is preparing itself in case the investigation turns into a formal suit.

Well, those were our comments. As of now, we are open for questions-and-answers.

Q&A

Operator

Thank you. At this time, we will begin the question-and-answer session. Our first question will come from Michael Gaugler of Janney Montgomery Scott. Please go ahead.

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

Good afternoon, everyone.

A - Mário Azevedo de Arruda Sampaio

Good afternoon, Michael.

A - Operator

Hi, Michael.

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

Just one question, gentlemen. I remember that prior to the drought, I believe it was 2016 or 2017, was going to be a time when SABESP and ARSESP considered adjusting tariffs and perhaps regulation from the initial regulation when it was implemented. And I'm wondering is that re-examination still planned or has that changed given the adjustments that were made during the recent drought conditions?

A - Mário Azevedo de Arruda Sampaio

Michael, I think you're making reference to the tariff review that is planned to occur in 2017. So the first cycle was from 2013 to 2016 and the second cycle will be from 2017 and four years. So there is no change that we are on track for that. The regulatory agency has not yet put out the schedule and agenda for the process. We're obviously waiting for that, but it's definitely a full-blown review, all the way from the WACC - regulatory WACC estimate to discussions around CapEx, OpEx, volume, X factor. Looking back, balancing all this period, we've gone through during the crisis which obviously change our business plan - agreed (25:42) business plan for this cycle, and all the adjustments needed as we move forward. Okay?

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

Okay. I do have a follow-up. I would guess that water volumes probably wouldn't increase until after the adjustments go away on May 1. Just wondering what your thoughts were maybe about how quickly volumes could return to the pre-drought levels by the customers?

A - Mário Azevedo de Arruda Sampaio

Okay. Okay, Michael. It's Mario again. Our understanding is that some memory will hold in there as we saw in 2004 when we adopted a similar bonus program. But at that time, we went through this about four to six months. Now, we are at 25 months almost. So I think this is very much impacting on behavior, so we don't know. We do expect recovery at some point, but very - not as steep as we saw in the past. Okay?

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

Okay. That's all I have.

A - Mário Azevedo de Arruda Sampaio

There's been a change in behavior. Okay.

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

All right. Thank you, gentlemen.

A - Mário Azevedo de Arruda Sampaio

Welcome.

Operator

And at this time, we will conclude the question-and-answer session. I would like to turn the conference back over to SABESP for their final remarks. I'm sorry, we do have another question, if you'd like to take it, and this will be from...

A - Mário Azevedo de Arruda Sampaio

Yes, yes. Let's take it.

Operator

Thank you. This will be from Carlo Remeika (28:01) of Covalis Capital. Please go ahead.

Good afternoon. Thank you very much for taking my question. I just had a quick follow-up on the WACC update. I was wondering if that's going to be a structural formula update. I mean, do you have some simple update, for example, for risk-free and cost of debt, or it's most probably going to be a debate in a sense that it's more qualitative?

A - Mário Azevedo de Arruda Sampaio

Carlos (28:31), let me check here with my colleague, especially he's the head of Tariff next to me, Mr. Silvio (28:38). Just a second. Carlos (28:48), we're not sure. It's not defined yet if there's going to be any change in previous methodology to estimate the WACC. We had one adopted methodology which we're not absolutely sure if it will happen again, especially and mostly in defining the debt component of the WACC. Okay?

Q - Operator

Understood.

A - Mário Azevedo de Arruda Sampaio

But we can do it at any time soon.

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Q - Operator

So, as I understand from the previous call that we had today, that around May we will see this further detail from ARSESP with some at least timeline. So, is that correct?

A - Mário Azevedo de Arruda Sampaio

Yes. We expect any time soon that they put out a schedule.

Q - Operator

And is that going to be just a schedule or something like basic guidelines, too, with it?

A - Mário Azevedo de Arruda Sampaio

Well, first, the schedule, and then we will know what's in front of us. And as we move forward, they will put out guidelines if there's any change upon the last methodology. And after that, we will all prepare our arguments around the WACC and we will start working on the business plan.

We will start reviewing how much the X factor, how much the business plan for this cycle is off track in all the components, I mean, OpEx, CapEx and volume and how much of the extraordinary tariff review we had in June did compensate for the past and is compensating for the future from that date to the end of the cycle. So, there's a lot in front of us, but we don't see today why we should have and go through the same tiresome postponements we went through to establish the first tariff cycle.

Q - Operator

Thank you very much.

A - Mário Azevedo de Arruda Sampaio

Okay. Welcome.

Operator

And at this time, there appear to be no further questions. I'd like to turn the conference back over to SABESP for their final remarks.

A - Mário Azevedo de Arruda Sampaio

Okay. Well, again, thank you very much for those who attended. And not many questions, but you can always call us and we will answer any of your questions in the IR team. So, see you next quarter. Goodbye.

Operator

Thank you. Ladies and gentlemen, the conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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