

Q2 2019 Earnings Call

Company Participants

- Marcelo Miyagui, SABESP
- Mario Arruda Sampaio, SABESP

Other Participants

- Hasan Doza, Senior Investment Analyst

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 Second Quarter of 2019. 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 slide show presentation available for download. (Operator Instructions)

Before proceeding, let me mention that forward-looking statements are being made under the safe harbor of Securities Litigation Reform Act of 1996. Forward-looking statements are based on the beliefs and assumptions at 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; Mario Arruda Sampaio, Head of Capital Market and Investor Relations; Silvio Xavier, Head of Costs and Tariffs; and Marcelo Miyagui, Head of Accounting. Please note this conference is being recorded. Now I'd like to turn the conference over to Mario Sampaio. Sir, you may begin your conference.

Mario Arruda Sampaio

Thank you. Thank you, all for attending our conference call to discuss our Second Quarter '19 presentation today. We will go through the main events and after, we'll have the usual Q&A session.

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Let's start on Slide 3. We show build volume increased by 2.6% for build volume of water and sewage in the Second Quarter of '19 as a result of essentially a 6.1% increase in build volume of sewage and 0.2% decrease in the build volume of water.

Let's go to Slide 4. Let's comment on our financial results. We reported a net income of BRL 454 million in the Second Quarter of '19. This compared to the BRL 181.9 million posted in the Second Quarter of 2018, represents a 149% bottom line increase. This change was due to the BRL 329 million year-over-year increase in gross operating revenues from BRL 3.25 billion in the Second Quarter of '18 to BRL 3.58 billion in the Second Quarter of '19 due to the 3.5% tariff report -- repositioning index and the 4.7% tariff adjustment also the increase in sewage volumes and the operation in the municipality of Guarulhos in this case representing a revenue increase of close to BRL 91 million.

Associated with this, the better financial results compared to the Second Quarter of '18 at BRL 681.6 million or 81.4% is mainly explained by the effect of monetary and exchange rate variations on the foreign currency loans and financing.

Second quarter net operating revenue increased 8.9% year-over-year from BRL 3.67 billion to BRL 3.99 billion. Costs, administrative and selling expenses and construction costs increased by 22.1%, the increase was distributed among the expense lines of which we can highlight the increase in expenses with services, general expenses and expenses with salary charges, benefits and social security obligations. Due to all these changes, adjusted EBITDA totaled BRL 1.23 billion, a decrease of 10.9% or BRL 151 million from the BRL 1.38 billion recorded in the same period last year.

Adjusted EBITDA margin in the quarter was 30.8% compared to 37.7% in the same period last year, resulting in a margin of 39.4% in the last 12 months. Excluding the effects of revenue and construction costs, adjusted EBITDA margin in this quarter was 36.8% compared to a 45.5% margin in the Second Quarter of '18. At the same time, the margin in the last 12 months reached 46.9%.

Go to Slide 5. Here we highlight the main changes in costs in the Second Quarter of 2019. As mentioned on the previous slide, cost, selling and administrative expenses and construction costs increased BRL 577 million or 22.1% year-over-year. Excluding construction costs, cost and administrative and selling expenses increased BRL 556 million or 28.3%. The main impacts on cost were BRL 134.9 million with outsourced services, BRL 117 million with general expenses and BRL 91.4 million in salaries, charges, benefits and social security obligations.

It is worth mentioning that general expenses were also impacted by nonrecurring events, such as the closure of lawsuits due to the signing of the contract service between the municipality of São Bernardo do Campo in the amount of BRL 39 million. In services, we also highlight the expenses related to all the current employees of the SAAE, which is the Guarulhos water and sewage company, of approximately 1,000 employees who were assigned to SABESP until June. This means that as of now the number of employees of the Guarulhos service company will be reduced to 400 in the next quarter.

The breakdown of these and other changes in cost are presented in our earnings release. You can get more details there.

But before moving on to the next slide, we would like to develop another analysis of the company's cost variation, which indicates that there has been no structural cost deterioration suggested when we simply compare this quarter to last quarter. But then again, let's go and see what this is. In this quarter, where we compared the variations of the company's cost and expenses before depreciation and amortization, estimated loss with bad debt and construction costs, we observed a 27.6% variation compared to the Second Quarter of '18. If we disregard the effects of the startup, the beginning of operations of Guarulhos, the PPP São Lourenço, both not present in the Second Quarter of 2018 results, plus the impacts of nonrecurring events this quarter, then the increase reaches 16.8%.

Just noting the nonrecurring events we consider are related to the São Bernardo do Campo that we mentioned before in the amount of BRL 39 million, Sabesprev pension fund in the amount of BRL 26 million and losses with emphasis on a labor claim of BRL 35 million. Additionally, when we analyze Second Quarter of 2018 costs, we noticed that it was atypically low, more precisely 3.1% lower than the Second Quarter of '17 in nominal terms. Therefore, in order to better evaluate the variations of cost in the Second Quarter of '18, we will use the comparison basis that seems to us to be more normalized and in line with previous quarter. In this case, that of the Second Quarter of 2017 itself.

If we estimate the nominal variation of costs in the Second Quarter of '19 compared then to Second Quarter of '17, adjusted for the effects of Guarulhos, PPP and the nonrecurring events mentioned above, we will reach a nominal variations of 13.2%. If we exclude inflation for the period that is a IPCA inflation of 7.8%, we now have a real increase of 5%. But note that this real increase. And this is important, accord along with an increase in build volume of 5.73% in the period, which is in line with the variation in costs in real terms.

It also follows from this brief retrospective that we will have a new base -- cost base in the future not only because of PPP São Lourenço and Guarulhos operations. But also because of the assumption of the municipality of Santo André, something that we have already made a material fact. So it's difficult to see more accurately today what will be the effects of the assumption of 2 major new concessions that require great effort from the company, especially in the initial period.

To get an idea, by incorporating Guarulhos, we committed to remove 800,000 people from water rationing within one year. However, as we began the work, we identified that the population subject to rationing or with some sort of relevant deficiency in the supply of water approach 1 million people. By the way, all of which were free from this situation already in the initial month of operation, which means we definitely put a lot of emphasis and a lot of power and a lot of people to make this work.

Well meeting this challenge quickly obviously has led to extraordinary cost and expenses, which is why we cannot say today what the recurring cost will be and what magnitude they will have.

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Let's go now to Slide 6. Slide summarizes the main year-over-year changes that impacted the company's net income in the Second Quarter of '19. As we already mentioned, net income totaled BRL 554 million; net operating revenue increased BRL 325 million; cost and expenses, including construction costs, increased BRL 577 million; other operating revenues and expenses, including the equity result, fell by BRL 15.7 million; the financial result was a positive of BRL 681 million. And finally, income tax and social contribution increased by BRL 141 million due to the higher taxable income reported in the Second Quarter of 2019, largely explained by the increase in operating revenue and the improvement in financial income that offsets the observed increase in cost and expenses.

Let's move to Slide 7. Let's comments at disclosing our material fact. SABESP concluded negotiations with the municipality of Santo Andr   and signed on July 31 a contract for the provision of water and sewage services and a debt settlement agreement. In practice, this means that SABESP will no longer supply water on a wholesale basis to the municipality but both water and sewage services directly to the end users. With this change, the service will be charged directly to the end user and not the municipality as before, eliminating the risk of major defaults from this platform.

The municipality of Santo Andr   has a population of approximately 692,000 and there is much to be done in basic sanitation, same as the municipality of Guarulhos, Santo Andr   and the areas that suffer daily from water shortages, a problem that will be resolved by us in six months' time. And to add to that, they also have very, very high water loss rates. Today, we estimate at around 45%.

Other commitments made in the contract include works to increase sewage treatment in the municipality from the current 42% to 75% in three years, improving the conditions of the region's creek streams and consequently contributing to the entire system of the metropolitan region. The agreement entered into effect runs for 40 years and SABESP will invest around BRL 917 million in this period.

In the first year of the contract, an amount of BRL 90 million will be transferred to the municipal fund. From the second year onwards, the amount equivalent of 4% of net revenue will be transferred to this fund and let's remember that this is the percentage allowed by the regulator to be passed on to tariff. So it will be passed on to tariff.

Also, there is a payment of BRL 70 million to be utilized by the Santo Andr   operation to close its water and sanitation activity. And again, in the same way as the agreement we reached with the City of Guarulhos, SABESP took into consideration the historical default rate of the municipality that was already in court collections in the amount of approximately BRL 3.5 billion. Also, the projected increase of this debt in the future flow of the company and the impact of this situation on its operation.

In the negotiation, also a discount of BRL 600 million was given on the interest and fines of the precatory notes being issued. These notes as well as those already issued will be suspended in court and will be given as security, as guarantee for the business, being progressively reduced over the term of the contract. And remember, if the service are interrupted by the municipality, these fees will be reactivated and in their original position

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in the queue before suspension and obviously will be charged. In other words, it's a very similar guarantee process that we incorporated in the Guarulhos contract.

It is also important to mention the signing of contracts with coastal municipalities that the company already operated, adapting all these old contracts to the Sanitation Law 11,445 of 2007. These municipalities includes very big municipalities and population, such as Guarujá, Bertioga, Mongaguá, Itanhaém and Peruíbe, all of them in the Baixada Santista de Santos metro region.

Also in the North Coast, we signed a contract with the biggest municipality, São Sebastião. In addition to that, as we already mentioned, we adjusted the contract with the municipality of São Bernardo. Just remember that in this case, this city sits in the metro region of São Paulo.

Well that concludes the slides. But we still have some comments, general comments, let's start with the comments on important disclosures made by ARSESP since our last conference call. On June 6, the regulator published the opening of Public Consultation No. 6 of '19, which deals with the methodology for applying the general quality index to be observed during this year and applied in the 2020 annual adjustment to inflation tariff increase. This mechanism seeks to increase the quality of services provided by SABESP by establishing indicator and targets that will be monitored by ARSESP that may affect revenues positively or negatively depending on the company's performance.

On July 22, SABESP submitted its contribution and requested the application of the index to begin in 2022 coinciding with the extra -- the ordinary tariff revision and together with the new X Factor parameter and clarification on the criteria for approximation of the values obtained in the disclosed metrics.

Another important disclosure made by the regulator was the opening of Public Consultation, which addresses the methodology and the criteria to update the regulatory asset base of the third ordinary tariff revision. The primary technical note disclosed by ARSESP raised important discussion points such as the procedures for updating the incremental regulatory asset base in accordance with the original accounting value, what was previously carried out by the replacement value methodology. And also the inclusion of new municipalities in the regulatory asset base.

Given the complexity and impact of this matter, the company understood that the deadline for submitting the contribution was insufficient and requested ARSESP an extension, which was accepted and moved from August 5 to September 24.

Another matter we would like to comment are the recent news related to Pinheiros River depollution project mostly being carried out by the media. Firstly, it is worth mentioning that this program is an initiative of the São Paulo State Government and its objective is to clean up the Pinheiros River body in a short period of time, improving its condition so that the population can effectively use and explore its surrounding.

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Another highlight is that the program involves not only SABESP, it also involves other state companies and departments such as EMAE, the water department DAEE and the environmental agency CETESB. Specifically for SABESP, investments will be made in sewage collection and sewage transportation to treatment plants serving the region. In addition, as there is still an impossibility of collecting all sewage from nonregular areas, special sewage treatment plants for informal urban setting areas, called EPIs, will also be built to further improve the conditions of streams flowing into the Pinheiros River, all with the objective of improving the water conditions in the river body. Those active investments were already foreseen in the company's investment plan, only that some were reprogram and anticipated. Therefore, there will be no change or impact on the value of the investment plan we had already disclosed.

The last comment is on our most recent debenture issuance. On July 24, we issued our 24th debenture in the amount of BRL 400 million. Something important is this issuance represents a milestone for the company, not only because it's our first infrastructure debt debenture. But also because we have reached a demand of 5x greater than the offer value that is 5x book, which indicates the company's solidity and growing interest of the sector -- the sanitation sector. In the addition to this, the strong demand made it possible for us to obtain the lowest rate and best maturity of all debentures we have issued. In fact, the 24th debenture had 2 series, the first in the amount of BRL 100 million with amortization that follows on the seventh year and a rate based on the IPCA plus 3.2%. The second issuance, the second tranche -- sorry, series was in the amount of BRL 300 million with amortizations on the eighth, ninth and 10th year and a 3.37% spread over the IPCA.

In terms of use of proceeds, they will be mostly utilized for infrastructure investments to adapt and modernize water supply system in 71 municipalities, all of which with the objective of reducing water loss rate.

So that concludes our comments. Let's see if we have some questions now. Thank you.

Questions And Answers

Operator

(Operator Instructions) And our first question today comes from Hasan Doza with WAM.

Q - Hasan Doza {BIO 17222230 <GO>}

Mario, two questions. First on the São Lourenço system. First question is, can you help please confirm the total cost, including both OpEx and the interest expense associated with operating the São Lourenço system on an annual basis, please?

A - Mario Arruda Sampaio

Okay. What is the second question also, Hasan?

Q - Hasan Doza {BIO 17222230 <GO>}

Sure. The second one I was going to ask is, is partly related to the first one, is how much are you recovering in rates off the total cost which you are incurring for the SÃ£o LourenÃ§o system?

A - Mario Arruda Sampaio

Okay. Let me just get the number and we'll comment second. Hasan, just one more second, very detailed. We'll get there. Hasan? Mario. We're struggling here to maybe understand better your question. Do you want to know the SÃ£o LourenÃ§o impact on OpEx or the...

Q - Hasan Doza {BIO 17222230 <GO>}

Yes, yes.

A - Mario Arruda Sampaio

The monthly whole payment? Okay. So the -- specifically, what is the OpEx impact of the SÃ£o LourenÃ§o, Miyagui, do we have that?

A - Marcelo Miyagui

In this quarter it was BRL 11 million.

A - Mario Arruda Sampaio

In this quarter, just the OpEx, BRL 11 million and how much...

Q - Hasan Doza {BIO 17222230 <GO>}

Is that a good number to -- I'm looking more for an annual run rate. So is that a good number to annualize or what do you gentlemen think is a good annual OpEx run rate of the spend?

A - Mario Arruda Sampaio

What I recall from the contract is that there is the monthly payment, which obviously includes the OpEx. And this is adjusted on a yearly basis. So if you were to annualize, I would think that this would be a good start. I just don't know when the reset date, the adjustment date is, if it's next month or if it was last month. So I don't know. But again, it is adjusted by inflation. It's not adjusted by the IPCA, it's adjusted by a local SÃ£o Paulo IPC index, that slightly variation on a monthly-monthly basis. Okay?

Q - Hasan Doza {BIO 17222230 <GO>}

Got it. That's clear. And on the interest expense, either you or Miyagui, can you please confirm either quarterly or an annual run rate the interest expense associated specifically with the SÃ£o LourenÃ§o system, please?

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A - Mario Arruda Sampaio

Okay. Let me check here. Hasan, the interest for the SÃ£o LourenÃ§o this quarter was BRL 53 million. And again, I think if you want to use this number on an annual base, I won't confirm it will be the same. But it is the number. The variation there is an estimate based on an NPV of the contract at a discount rate, internal discount rate. So potentially this has normalized some. As for all these costs going through -- to the tariff, the answer is yes. In fact, the entire installed -- monthly installment, including OpEx, CapEx and interest, they all go through the tariff on the OpEx side. Okay? On the OpEx line, sorry.

Q - Hasan Doza {BIO 17222230 <GO>}

Okay. I got it. But I just want to confirm. So your OpEx run rate is about BRL 40 million per year, as you said, BRL 11 million this quarter and your interest expense run rate I'm rounding at BRL 50 million. So call it BRL 200 million annual. So these 2 costs, BRL 240 million annual run rate. I just want to confirm, for example, when you received that 4.7% tariff increase on May of this year, was that BRL 240 million or whatever the exact cost is of the SÃ£o LourenÃ§o system both at the OpEx and the interest expense level, were these costs included in that 4.7% tariff adjustment?

A - Mario Arruda Sampaio

Okay. Hasan, first, let's do this. The 4.7% is a tariff adjustment to inflation. So you must be referring to the tariff reset of 3.5% the year before. Said that, under our business plan, the entire, for the period, payment outlays to the SÃ£o LourenÃ§o contract were registered as OpEx and yes, they are considered in the 3 -- our tariffs and on the 3.5% increase. Although you have to remember, only today we are at full operation in SÃ£o LourenÃ§o. So SÃ£o LourenÃ§o effectively started around August last year. So the answer to you is yes. It is captured fully by the business plan and by the tariff that is authorized by the regulator.

Q - Hasan Doza {BIO 17222230 <GO>}

Okay. So final question on this plan. So when you go for your tariff -- when you go for your regular tariff adjustment in 2020, which is the inflation-type increase in April or May of 2020. And you now have a full year run rate of operating the SÃ£o LourenÃ§o plant. Will you be, as part of the regular tariff adjustment in 2020, be able to fully recover the costs of SÃ£o LourenÃ§o on an annual basis?

A - Mario Arruda Sampaio

We will fully recover because it's already on the tariff. And we should maintain that recovery provided that the adjustment on a yearly basis for the SÃ£o LourenÃ§o payment is not exactly the same inflation index but the similar inflation index. So ultimately, what we're saying is yes, the SÃ£o LourenÃ§o contract is being fully recovered in the tariff and yes, every year where there is a tariff adjustment on our tariff, that adjustment is more than sufficient to capture the adjustment in the contract payment -- yearly payment.

Q - Hasan Doza {BIO 17222230 <GO>}

Perfect. That's very helpful. Just 2 quick questions. Mario, can you please confirm or Miyagui, the statutory tax rate that you are currently paying in Brazil?

A - Mario Arruda Sampaio

The statutory tax...

Q - Hasan Doza {BIO 17222230 <GO>}

Statutory tax rate, yes.

A - Marcelo Miyagui

34%.

A - Mario Arruda Sampaio

34%. Okay? Hasan, 34%.

Q - Hasan Doza {BIO 17222230 <GO>}

That's fine. I got you. And just want to close with your statement on the change in the employees from Guarulhos. You mentioned that it goes from 1,000 to 400. So what's happening to those 600 employees? Can you just, I mean, help me understand?

A - Mario Arruda Sampaio

Yes. Yes. Let me tell you. First, they are not employees of SABESP. They are employees of the Guarulhos sanitation company, the one that is not operating the system anymore. So under the contract, we have the possibility to -- not to hire their employees. But to pay them as service provided by them during a period. The first period, we paid the service for slightly above 1,000. That agreement was until June this year. So yes, until June on the service line, we pay for 1,000 employees supporting our work as we take over the system.

As of now, we are allowed to contract services from 400, which we will. We may remain with these 400 for four years. After which, we are not obligated to pay for their services, which doesn't mean that we may remain with 1 or 2, 10, whatever we think are good employees. But then only then if it happens, they will become of our employees. So it's not on the payroll salary line. This you will always see until we are providing -- they are providing the service in the service line.

Operator

(Operator Instructions) It appears there are no further questions. I would now like to turn the conference back over to SABESP for their final remarks.

And this will conclude the question-and-answer session. I'd like to turn the conference back over to SABESP for their final remarks.

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A - Mario Arruda Sampaio

(technical difficulty)

and see you next quarter. Thanks. Bye.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time and have a great day.

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