

Q2 2016 Earnings Call

Company Participants

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

Other Participants

- Michael Gaugler, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to SABESP Conference Call to discuss its Results for the Second Quarter of 2016. The audio for this conference is being broadcasted 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.

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. This call is being recorded.

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 Markets and Investor Relations; 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 for all those attending this conference call. Here, we intend to discuss the results for the second quarter and the water situation in the São Paulo Metro region and also the first steps into the second ordinary tariff review process. This is a 10-slide presentation and at the end, as usual, we will open for a Q&A session.

Now moving to slide three, let's start there. We show the company's billed water and sewage volume, which was up by 5.4% in the second quarter of 2016 with an increase of 4.7% in water and 6.3% in sewage when compared with the second quarter of 2015. This quarter followed the trends observed last quarter and billed volume, as you saw, continued to grow. With increased water availability and demand at the same time, production volume increased 10.4% in this quarter and 9.6% in the first six months of 2016.

Let's now move to slide four. Let's quickly go through our financial results. Net operating revenue increased 21.8% over the same period last year chiefly due to the 15.2% tariff increase granted in June 2015, 7.8% of which from the ordinary tariff revision and 6.9% from the extraordinary tariff revision; also, due to the 8.4% tariff increase effective as of May 2016, the lower granting of bonuses with an impact of BRL 33.6 million in second quarter 2016 against BRL 231 million in second quarter 2015; also, the lower application of the contingency tariff with an impact of BRL 64 million this quarter against BRL 123 million same quarter last year; and finally, the 5.4% upturn in total billed volume, 4.7% of which in water and 6.3% in sewage, as mentioned on the previous slide.

Costs and selling, administrative and construction expenses increased 11.3% in the period. The adjusted EBITDA increased 47.6% to BRL 1.1 billion from BRL 756 million in the same period last year, while the adjusted EBITDA margin came to 32.5% in second quarter 2015 (sic) [2016] (5:19) against 26.8% in second quarter 2015. If we exclude construction revenue and cost, the adjusted EBITDA margin came to 43.2% second quarter 2016 against 38.4% in second quarter 2015. Net income totaled BRL 797.5 million against a net income of BRL 337.3 million in second quarter 2015.

Now, on slide five, we will discuss the main variations in costs in relation to second quarter last year. In comparison with the second quarter then, construction costs and expenses increased 11.3%. Excluding construction costs, costs and expenses climbed 18.6%. Other items that increased were general expenses 242% up, payroll benefits and pension plan obligations also up by 17.5%, service is up 17.1%, and electricity up 16.6%. It's also worth highlighting a 35.8% decline in the allowance for doubtful accounts. And again, for a more detailed explanation, please refer to our earnings release, which presents greater breakdown of cost variation.

Now on slide six, we present, in fact, the main variations that affected our net income between second quarter last year and this year. And, as mentioned, that totaled BRL 797 million. Net operating revenue increased BRL 715.7 million (sic) [BRL 615.7 million] (7:10) or 21.8%. Cost and expenses, including construction costs, increased BRL 265.1 million or 11.3%. Other operating revenues and expenses recorded a positive variation of BRL 4.3 million. Net financial expenses, monetary restatements and foreign exchange variations had a positive increase of BRL 217.3 million due to the increased depreciation of the dollar against the real in second quarter 2016 that is a negative 9.8% compared with the devaluation in the second quarter 2015 of negative 3.3%. Finally, income tax and social

contribution increased BRL 112 million. This is mostly due to the higher taxable income between second quarter 2015 and second quarter 2016.

Let's move to slide seven. Let's talk about rainfall for this last period. As we can see, it was very atypical and irregular in this quarter. After a very dry April, rainfall was well above average in May and June, especially in June, but it was 319% above the historical average, leading to an increase in the Cantareira System water reservoir levels exactly during the dry season.

July, on the other hand, had very low rainfall with only 5.9 millimeters versus the historical average of 49.9 millimeters. However, and again, it is important to note that the period from April to September is dry season and the reduction in rainfall and reservoir levels are expected every year. In August, as you can see, rainfall is still well below average, but we understand that we have still 15 days ahead of us.

Now, let's go to slide eight. Here, we'll talk about water inflow into the Cantareira System. Here, you can see that the reservoirs of the Cantareira System, which similarly to rainfall, fluctuated or varied during the quarter, registering below average figures in April and May and well above average in June. It's important to note that although water inflow was below average in April and May, it was substantially higher than in the same month in 2014 and 2015. In fact, this is very relevant.

On slide nine and 10, we will comment on the general situation of the reservoirs that supply the São Paulo Metro region as compared to 2015 and 2014. As we already mentioned in the conference call held in May, in the rainy season, which began October 2015 and ended March 2016, rainfall and water inflow returned to the averages expected for the period, improving the reservoir levels that supply the São Paulo Metro region.

The collaboration of the population in saving water, the measures taken to manage water supply and demand, the emergency works carried out by the company in rainfall in line with expected average for the rainy period allowed us to achieve higher stored volume on August 11, 2016 than in the same date in 2014 and 2015, in fact, much more.

The scenario makes clear, then, that the water crisis is over and existing water in the reservoirs is sufficient to safely supply the population until the arrival of the rainy season in October. In fact, this was the main condition achieved and that led to the cancellation of the bonus program and the contingency rate tariff since the month of May.

Now, let's move to slide 10. Here, we also show a comparison between available volume now and in 2014. Again, August 11, 2016, the reservoirs of the metro region that São Paulo stored 1.240 trillion liters against 510 billion liters in the same date in 2015 and 449 billion liters in 2014 including in all these cases the technical reserve. At the moment, the company has 730 billion liters more than in 2015 and 791 billion more liters than in 2014.

The recovery of the Cantareira System is also evident in terms of population served. Before the crisis, this system covered 9 million people. At the peak of the water crisis, this figure reduced to 5.4 million people and today is at 7.4 million people.

Let's go to our next slide, slide 11. In this slide, we will comment on the recent developments for the second tariff review, ordinary tariff review scheduled to be concluded by the first half of 2017.

Although ARSESP has not yet made public a full agenda for all aspects of the process, on June 30, it disclosed for Public Consultation the general criteria the methodology for estimating the regulatory asset base. On the company's side, on July 15, we submitted our contributions to ARSESP who has up to two months as of then, that is of June 30, to conclude the public hearing and make public its final decision, criteria, and methodology.

In general terms, in comparing ARSESP's proposal (13:29) comments, we like to highlight the following points. First, ARSESP does not explicitly mention the eligibility and prudence criteria that will be adopted for the emergency investments. As you remember, they were made as a result of the water crisis.

In this respect, the company requests that investments in emergency was carried out to guarantee water supply to the metro region to be recognized as prudent and thus be included in regulatory asset base of the second ordinary tariff revision based on and in line with Resolution 002 of 2015 provided by the State Sanitation Council, which is called CONESAN, which approve the investments undertaken.

Second, regarding the assets incorporated from the assumption of new municipality, ARSESP proposes that the value added to the regulatory asset base should be referenced in its replacement value where the amount actually paid by SABESP to the municipality at the time of its assumption. SABESP, on the other hand, proposes that the assets that will be incorporated by the assumption of new municipality should be included in the regulatory asset base only according to its estimated replacement value regardless of the economic and financial condition established in the contract with these municipalities.

Next, regarding the monetary adjustment index for the asset base and new investments undertaking during the first cycle, ARSESP proposed the use of the EPCA, the consumer price index. On our side, the company, considering that the EPCA is not directly correlated to the behavior of construction prices, is proposing the INCC, which is the National Civil Construction Index.

Next, regarding the reduction in the proposed asset base value made by ARSESP in the first tariff cycle, with pipes being the main item with an estimated value of BRL 6 billion, ARSESP did not comment or made any reference in its proposal. And for this reason, the company has requested the reopening of the discussion based on ARSESP first tariff cycle detailed public consultation report number 001/2014 in its item 7.6.1 in which ARSESP when referring to SABESP argument (16:15) in this matter appear to be open to a further detailed discussion.

Regarding the utilization rate of the water and sewage treatment stations, rates to be adopted for estimating growth projections for the next 10 years, ARSESP proposes to reference on the installed capacity utilization in the last 12 months. The company, however, proposes to reference the utilization ratio reported before the water crisis

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considering that the drought in 2014 and 2015 had strongly impacted on maximum production and treatment flows affecting obviously negatively the utilization rate in this period.

One more, since the completion of the first tariff cycle, ARSESP - we (17:08) did not receive from ARSESP the analytical regulatory asset base report with specific values individually recognized and those excluded. To this date, this information has not been made available by the regulator. SABESP has informed the regulator that it will - that all asset inclusion, exclusion and value updating for this second plus (17:35) cycle will be performed by us using the individualized information that we provided during the first cycle discussion.

Now, regardless of this situation, SABESP has requested ARSESP to clearly inform what will be the treatment agreement to the asset base in this second annual rate review in such to mitigate uncertainties and possible delays in the process.

Another important topic we would like to briefly comment relates to the tariff structure. As you already know, the current tariff structure is very progressive with subsidies running between regions and consumer categories. For this matter, we have been performing a series of studies, although without yet having reached a final conclusion. However, please bear in mind that our goal is not to increase revenue, but to have a less progressive billing system to make it easier for lower-income consumers to pay their bills.

Let's move to our last slide. Here, we will comment on our EBITDA, our total debt-to-EBITDA multiple and the dollar performance from 2013 to today. As you can see, EBITDA grew consistently throughout 2013 until the first quarter of 2014 when the first measures to fight and to face the worst water crisis in 84 years were announced.

The steep decline in EBITDA during 2014 as a result of the water crisis placed total debt-to-EBITDA multiple under pressure, surpassing the historical average, which had been 2.5 times in recent years, and brought it close to the covenant multiple limit of 3.65 times.

At first, on a smaller scale, the depreciation of the real against the dollar contributed to increase the pressure on this multiple. Now, on 2015, pressure on the total debt to EBITDA multiple continued. But at this time, due to a steeper devaluation of the real and its impact on our foreign exchange debt and total debt. The negative effect of the real devaluation on this multiple, as you can see, was well offset by a continued improvement in EBITDA quarter-over-quarter.

It's worth noting that during the water crisis, the company managed its financial covenants and multiples in a very rigorous and prudent manner, especially if debt multiples being able to lift through the water crisis and at the time of great exchange rate pressure and volatility, maintain them within covenant compliance limits at all time. These measures included cost reductions, credit recovery, reduction in investment, and proactive management of debt maturities.

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Although we're not certain when revenue and EBITDA will return to pre-crisis levels, the recovery of EBITDA throughout 2015 and especially in the beginning of this year has resulted in a total debt to EBITDA ratio reduction and its proximity to historical values. This ratio in this quarter ended at 3.0 times, very close to below 3 times against 3.27 times in second quarter 2015 with dollar levels, by the way, very similar to those recorded in the first quarter of last year.

All these were our remarks. Now, we're open for question and answers.

Q&A

Operator

Our first question comes from Michael Gaugler of Janney Montgomery Scott. Please go ahead.

Q - Michael Gaugler {BIO 7139923 <GO>}

Good afternoon, everyone.

Good afternoon, Michael.

A - Operator

Hi, Michael.

<": Congrats on a nice quarter. I was just wondering if you could remind us of the timeline for the ARSESP discussions for this new rate methodology and perhaps when you'd be looking to conclude. "

A - Mário Azevedo de Arruda Sampaio

Hey, Michael. The official timeline has not been disclosed by the regulator so far. But as you can see, they have started the process. This is the first move, the discussion around the methodology. And once this is done, we will start working on the appraisal, the bidding process to bring the consultants on our side and their side.

On the other hand, obviously, we're anxious to know the next steps and the dates. But one thing is for sure. We're very confident that by April next year, we should have the tariff revision concluded, if anything, all the way to June. But that's our call right now.

Q - Michael Gaugler {BIO 7139923 <GO>}

All right. That's all I had, gentlemen. Thank you.

A - Mário Azevedo de Arruda Sampaio

Thanks, Michael.

Operator

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

A - Mário Azevedo de Arruda Sampaio

Okay. Once more, thank you for your participation and I'll see you guys everybody on November for the third quarter. Bye, bye.

Operator

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

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