

Q1 2017 Earnings Call

Company Participants

- Mario Azevedo de Arruda Sampaio, Head of Capital Markets and Investor Relations
- Rui de Britto Alvares Affonso, Chief Financial Officer and Investor Relations Officer

Other Participants

- Humberto Medina, Analyst
- Lilyanna Yang, Analyst
- Michael Gaugler, 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 2017. The audio for this conference is being broadcast simultaneously through the Internet on the website www.sabesp.com.br and on the Engage-X platform, where you can also find the slide show 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. (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. Benedito Braga, Chairman; Mr. Jerson Kelman, CEO; Mr. Rui Affonso, Chief Financial Officer; Mr. Marcelo Miyagui, Head of Accounting; Mr. Mario Arruda Sampaio, Head of Capital Market and Investor Relations; and Mr. Sylvio Xavier [ph], Head of Costs and Tariffs.

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

Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay, good morning, everybody and thank you for attending this conference call. Here, we will discuss the results for the first quarter '17, talk a little bit about tariff revision and the material fact on the approval by the State for us to initiate studies on a possible capitalization of SABESP. So we have here, specifically in terms of slide four. So let's move on those and afterwards, we're going to have a Q&A question.

Also starting on slide three, we show the companies billed water volume and sewage volume, which was up 6% in the first quarter of '17 with an increase of 6.1% in water and 5.9% in sewage.

On this slide, you can also see billed water volume behavior, which has been increasing and improving since the third quarter of 2015, when the water situation began to improve. In this quarter, billed water and sewage volume was equivalent to the billed volume in the third quarter of '13, so we are picking up a very hot period right before the beginning of the water crisis. Okay.

Let's move to slide four, let's talk very quickly on the financial results. Net operating revenue increased 17.5% over the first quarter of '16, chiefly due to the 8.4% tariff increase since May '16, the 6% increase in total billed volume, 6.1% of which in water and 5.9% in sewage and the granting of bonus totaling 153 million in the first quarter of '16, which is not present anymore and at the time, this was part of the crisis demand control. So again, this descended on April not affected -- not present now. It is worth also noting that the increased cost by these factors we have just mentioned was partly offset by the end of the contingency tariff also which totaled a 160 million in the first quarter of '16.

Costs and selling, administrative and construction expenses increased 5.5 or BRL132 million in the period. Adjusted EBITDA totaled 1.4 billion, 49.1% higher than the 907 million recorded in the same period last year. The adjusted EBITDA margin came to 38% in the first quarter of '17 against 30 in the first quarter of '16. If we exclude the construction revenue and construction costs, the adjusted EBITDA margin was 47.2% in the first quarter '17 against 37.2% in the same period last year.

Quick note, 47% is higher than the average we had pre-crisis. Net income totaled 674 million against 628 million in the first quarter of '16.

Let's move to slide five, let's discuss the main variations in costs in the first quarter. In comparison with the first quarter of '16, cost expenses, including construction costs increased 5.5%. Excluding these construction costs, costs and expenses climbed by 2.1% from year-to-year. Cost and expenses represented 71.3% of net revenue in the first quarter of '17 versus 79.5 in the same period last year. This increase was mainly led by 53.5% upturn in estimated losses with doubtful accounts. And it's worth noting that

decline in 16.9% in electricity and 6.9% in general expenses. Again for more details, please refer to our press release and the earning release, you'll get the detail there.

But still, let's move to slide six, let's present the main variations between the first quarter '16 with the first quarter '17 and the items that affected our net income, which totaled 674 million. Net operating revenue increased 531 million or 17.5%, costs and expenses including construction costs grew 132 million or 5.5%. Other operating revenues and expenses were 4.8 million. Net monetary exchange rate variations in financial expenses had a negative variation of 336 million.

This was mainly due to the lower dollar depreciation and the appreciation of the yen against the real in the first quarter of '17, basically 2.8% and -- negative and positive 1.9% respectively. Compared with the devaluation of these currencies in the first quarter of '16, which was negative 8.9% and negative 2.4% respectively.

Finally, on the slide income tax and social contribution moved up 21.4 million. This was mainly due to the increase in operating revenues. These upturns were partly offset by the worst financial result in the period impacted by exchange rate fluctuations.

Now, let's comment on the tariff, which we mentioned in the beginning. On May 9, we issued a material fact requesting ARSESP to postpone this stage, the preliminary stage of the tariff's process in 30 days. And the next day, ARSESP published the authorization 722 that granted the postponement.

The reason that we asked for this postponement is our understanding that the process is complex and needs further improvement as we move. In this sense, we had to make a choice between timeline or the quality of the regulatory process. We chose the quality. A specific point that we -- that drove our decision refers to the exclusion of networks from the asset base in the first cycle, if you remember, the nominal value at the time was BRL6 billion, so we want to work on that.

Considering that, we concluded our studies to present to the regulator on this subject, we saw that no need for this discussion to be left for the final stage of the tariff's review in April 2018. For this reason and considering that we understand that ARSESP will need more time to review this document, we asked for the postponement.

To this point, it's worth remembering that ARSESP faced a hard time undertaking the bidding process to hire the needed consultant for the implementation of the tariff review. This is mostly due to the complexity of the process, but the good news is that they just overcame this problem and are now in a better position to run this process.

Last, as mentioned before, the tariff revision process requires processing a large amount of information and details. So with more time for this for us to provide information and the regulator to analyze, again, we think this is going to be a more precise and the results will be better.

Let's move now to the next subject, which is the capitalization of SABESP. Last Friday, we published a material fact making reference to the approval of the State of Sao Paulo public sector reduction program that authorized hiring consultants to undertake studies that will make possible SABESP to capitalize itself. This initiative is driven by the demand from society for us to accelerate investments and reach full sanitation on a shorter period of time.

Considering that the Company finds itself in a prudent indebtedness level, any initiatives to do this will be through credit, business loans and debt issuance and we'll take it -- and this will take it to a debt level undesirable. So the only way to do this is capitalizing the Company.

Now, considering that the Government of Sao Paulo is in the limits of dilution of its control, the only way we could do this is with the equity from the private sector. But, how to do this? But before talking about this, let's outline the basic assumptions that will guide this process. First and foremost, we needed to maintain the State Government control, so there will be no privatization, needs to secure all concession contracts and our relationships with the municipalities, so we not put at risk our concession base, which means our revenue. Maintain our access to multi-lateral important long-term and low cost funding. Obviously, respect and deal with the best governments and transparency possible, the best [ph] minority shareholders.

Very important, maintain the Company listed in the Novo Mercado in BOVESPA and the capitalization of SABESP will be made, if made, will be made through a public offering. In this way, what is being done now and that's important and was approved, our studies to find the best way to achieve this objective. Also important to highlight is that all this process will have to go back to the State Government, public sector reduction program, that's the same that just approved the beginning of the studies as much as it needs and will need approval from the State legislative branch.

So this finalizes this presentation. Now, we will move into the Q&A questions.

Questions And Answers

Operator

(Operator Instructions) Our first question is from Michael -- excuse me, Gaugler with Janney. Please go ahead.

Q - Michael Gaugler {BIO 7139923 <GO>}

Good morning, everyone.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Good morning, hi.

Q - Michael Gaugler {BIO 7139923 <GO>}

Maybe you could just give us a little more color on what -- how you would be using the proceeds from this potential public offering? What the thoughts are around that?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Okay, Michael, a second.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Hi, Michael, it's Rui. The usual [ph] proceeds of these potential capitalization of SABESP. The intention here is to improve our CapEx expansion capacity without any compromise with our sustainability [ph] in our financial index. So the proposal is special and with the same good results we have been able to prove to you, our investors. That's the point.

Q - Michael Gaugler {BIO 7139923 <GO>}

Okay. I guess, what I was thinking about was more, is it simply to pay down debt, avoid debt or perhaps make acquisitions outside of your core geographic region?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

As we used to say, the main goal SABESP and the lower hanging fruits in Sao Paulo, inside Sao Paulo and inside our operation base, there's lots of growth opportunities already. If your goal outside, outside I mean outside Sao Paulo or outside our main field [ph] of operation should be something very close what we have already done. I mean, some other businesses very tightly connected with water and sanitation, like waste to energy, like reuse -- water -- reuse of water and so on so forth.

Q - Michael Gaugler {BIO 7139923 <GO>}

Okay. All right, gentlemen. It's really all I had.

Operator

Our next question comes from Lilyanna Yang with HSBC. Please go ahead.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Hi, thanks for the opportunity again. You mentioned the earlier call in Portuguese that the capital increase idea is in the initial stages that it would up take up to 12 months to have it and the goal will be to actually have better government standard by bringing investors at a holding company level. We're fine with that, actually I do see the benefits there.

I was just wondering, if you could give a little bit more color on the potential capital increase at SABESP, right? Sorry to insist on the question, but I wonder what is the best targeted net debt to EBITDA level for the Company that if you think you should go below the two times net debt, which we think is maybe not ideal especially when taking to account that the late interest rates in Brazil are coming down and faster than anticipated?

And I wonder, if you could also give us a little bit more of color on what you expect to achieve in the rate review negotiation on a preliminary basis for this year in June, actually now in July? If you think that you have good chances of having the regulator assuming the tariffs, the BRL7 billion in regulatory asset base that had been disputed since 2012. Thank you.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

All right. Hi, Lilyanna, it's Mario. On your first question, the objective is to stay on the net debt and total debt levels that we are today. We're not going to deleverage and we don't want to leverage. The entire objective is to increase and accelerate investments without further increasing indebtedness. On the other hand, it's not to be down, debt is not to pay dividends, it's essentially to run the business in more speed and higher level investment rate. I think that said, I will pass the word for the second to Rui. Just a second.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Thank you, Mario.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Hi, Lilyanna, it's Rui. As you probably agree we don't have the ability to know how ARSESP will consider from our request this pending seven point something billion reais pending on the first cycle. We are working on that. We present to them several detail, huge research that we have made, so we try to get the most.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Yeah.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

But we have no idea the result at the end of the day how, part of -- percentage of this request they will at the end of the day consider.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Yeah. So it's more likely they will consider this year or you think that the outcome might still come out only next year or later?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Well, the proposal of our -- the postpone of -- at -- the field study days was to give them time and elements to consider at least part of this BRL6 billion to BRL7 billion left behind from the first cycle, that's the proposal. But we realize how much they -- can be able to analyze first and then to -- and second to consider.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Okay, thank you.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Okay.

Operator

Our next question is from Humberto Medina with C&S. Please go ahead.

Q - Humberto Medina {BIO 16770607 <GO>}

Hey, guys. Thank you for the call. I had two questions. The first one is, I wanted to make sure going back to what Lilyanna talked about that under no circumstances the capital raise would come ahead of the rate, pending rate increase that was just delayed. And then the second question is, I want to clarify, would the State of Sao Paulo sell part of their ownership or the dilution would come just by raising additional capital? And then just obviously -- by Sao Paulo not really selling but getting diluted. Thank you.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Okay. Humberto, just a second please. Just a second, one more second. Look Humberto on the second question, the government has to keep control in any case as much as he has today. So there is a vehicle, which will be used, he has to keep control on that. Now, if he is going to be diluting or not, it's not what we're in discussion here. The discussion here is, how can we bring additional capital, raise capital to -- in such that we can issue shares at SABESP and increase the equity in SABESP. So that's what --

Q - Humberto Medina {BIO 16770607 <GO>}

Yeah. I understand that. I guess, the question I have is, would the State of Sao Paulo sell a portion of their stake as part of this process or would they not sell and just raise additional capital and therefore through raising the capital, they will get diluted?

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

Look the point Humberto is that, we will undertake studies, okay. We have enough information that we think it's something worth going after. Now, what and how it's going to work and whatever comes out does or does not open the door for the government to dilute itself without losing control that's really of their decision. This is not the discussion, that was not the decision that was made by the government at this point and this is -- and what we're now seeing here and just having a discussion with you. In any case and whatever happens, there is only one thing we all know, the State is not going to lose control. Okay?

Q - Humberto Medina {BIO 16770607 <GO>}

Okay. We can follow up on that. Thank you, guys. And what about the timing of this? You mentioned that obviously it's early stages, is there any scenario under which the capital raise could come ahead of the rate increase that is pending?

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Hey, just a second. Humberto, Rui is going to answer.

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

So, hi, Humberto. Despite the fact that the two process are interconnected, I mean, the tariff revision and the capitalization of capitalization of SABESP, they are different in a sense that we can -- we need and we count with robust tariff revision, as including -- as inclusive as a part, as a support of the capitalization. What I tried to say that there is no trade-off between one thing and the other. We are trying to move fast and get a robust tariff revision, the provisory [ph] one right now and the final one at the beginning of 2018. And to get the conclusion of the process of capitalization of SABESP in front, I believe at the end of this year.

In the first call, we said that it's very important to conclude it the capitalization of SABESP before 2018 in order to avoid some contamination of this very technical process with political agenda in 2018. So despite the fact that our connections, you are right, we are trying to treat those (inaudible) movements separate.

Q - Humberto Medina {BIO 16770607 <GO>}

Got it. Thank you very much, guys. I'll see you soon --

A - Rui de Britto Alvares Affonso {BIO 5808118 <GO>}

See you soon.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

See you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back to SABESP for their closing remarks.

A - Mario Azevedo de Arruda Sampaio {BIO 16570252 <GO>}

Well, first, thank everybody for participating. I think to take advantage to comment that today SABESP management is in New York at the New York Stock Exchange. We are celebrating 15 years of our ADR program. So hope to see you next quarter, and in five years for the 20 years. Thank you very much. Bye bye.

Operator

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

FINAL

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