

## Q2 2015 Earnings Call

### Company Participants

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

### Other Participants

- Douglas Newton, Analyst
- Michael E. Gaugler, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good afternoon, ladies and gentlemen. At this time, we would like to welcome everyone to the SABESP's Conference Call to discuss its results for the Second Quarter of 2015. The audio for this conference is being broadcast simultaneously through the Internet in the website, [www.sabesp.com.br](http://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.

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; Mr. 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. Thank you. And, again, good afternoon, everybody, for one more earnings conference call. We have a nine slide presentation today to discuss the second quarter of 2015. And as already mentioned, after that, we will open for the Q&A session.

Let's start on slide three. Here we show the company's billed water and sewage volume, which fell 7.5% between second quarter last year and second quarter this year. This is due to the decline in water availability and consequently the measures adopted since February 2014 to continue supplying the population in the metro region of São Paulo on an ongoing basis. As a result of the water crisis, there was also a substantial decline in water production. Volume was 14.6% down in the quarter and 18.1% down in the first six months of this year.

On the next slide, on fourth, we will discuss our financial results. Net operating revenue increased 2.5% compared to last year's second quarter. Excluding construction revenue, net operating revenue decreased 7.6%. This is due to the granting of bonuses and the 7.5% reduction in total billed volume, as we mentioned in the previous slide. The decrease was mitigated by the application of the contingency tariff and the application of the repositioning tariff index of 6.5% since December 2014. You all are already aware and familiar with, and plus the 15.2% tariff increase effective since June and impacting only 1.5% in this quarter. I would like also to remind you that this last tariff increase includes a 6.9% increase due to the extraordinary tariff revision. The balance to the 15.2% is the ordinary annual tariff adjustment to inflation, which happened in April.

Cost and selling, administrative and construction expenses increased 1.5% in the period. If we exclude construction costs, there was a decline actually of 11.2%. Adjusted EBITDA increased 14.3% to R\$756.6 million from R\$661.7 million in the same period of 2014. It's worth noting that in the last 12 months, adjusted EBITDA reached R\$3.4 billion. Yet, adjusted EBITDA margin came to 26.8% versus 24% in the second quarter of 2014.

In fact, in the last 12 months, the EBITDA margin stood at 30.6%. If we exclude construction revenue and cost, the adjusted EBITDA margin came to 38.4% in the second quarter of 2014 against 31.2% in the second quarter of 2014 and 42.4% in the last 12 months. Net income totaled R\$337.3 million. That is 11.5% higher than in the same period of last year.

On slide five, we will move in to it and discuss the main variations in costs and expenses in relation to second quarter last year. Mentioned before, in comparison with the second quarter cost expenses increased R\$1.5 million, and excluding construction cost, it was a decline of R\$11.2 million.

This quarter, all the cost items recorded were below second quarter 2014, except for tax expenses which increased by 0.7%; depreciation and amortization went up by 27.6%; and electric power cost, which rose by 44.2%, something we had already anticipated to everybody that would happen last quarter.

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In the reduction side, it's worth highlighting the decline of 74.4% in general expenses, 23.2% in services and 4.1% in payroll and related charges, the last - these three corresponding to a large share or the bulk share of our total costs. For a more detailed information on our cost variation we ask you to refer to our detailed earnings release.

Let's move on to slide six. Here we present the main variations and the items that affected our net income which totaled, again, R\$337 million. Net operating revenue increased by R\$68.8 million or 2.5%. Cost and expenses, again, including construction cost increased R\$35.3 million or 1.5%. Other operating revenues and expenses recorded a positive variation of R\$6.4 million. Net financial expenses, monetary restatement and foreign exchange variations fell R\$177 million in the period. Finally, income tax and social contribution increased R\$182 million when compared to second quarter 2014.

Let's move to the next slides on - in fact the next two slides, seven and eight. We will update you on rainfall and water inflow into the Cantareira System reservoirs. The year of 2015 has been recording irregular rainfall and extremely dry winter. In July, of the three main systems, we used to supply water to the São Paulo metro region that is the Cantareira, the Alto Tietê and the Guarapiranga systems. Of these, the Cantareira system was the only one that recorded below average rainfall.

We're still operating, in fact, in the Cantareira with the first portion of the system's technical reserve. And the other interesting thing is that today the Guarapiranga system has a relevant growth in supplying water to the entire metro region of São Paulo. In fact, today's again surpassing the Cantareira system.

On slide eight, we can see that the water inflow into the Cantareira system reservoirs came to 11.3 cubic meters per second. In July, which despite being low or below historical leverage, it's almost the double of the volume recorded in July 2014 when water inflow came to only 6.4 cubic meters per second. In the first two weeks of August water inflow has been lower than in August last year. However, the month has not ended yet. We still have 13 days in front of us. It's also important to note that August is usually a dry month and reservoir levels are expected to decline in this period.

In fact, for this month, SABESP received from the National Water Agency, ANA, and the State Electric Power and Water Department it's called DAEE an authorization to increase water withdrawal from the Cantareira system from 13.5 cubic meters per second in July to 14.5 cubic meters per second in August. This water withdraw increase by 1 additional cubic meters from the Cantareira system reflects the need to spare the Alto Tietê system whose water inflow has been lower this year than last year.

Well, let's go to slide nine and give you an update on the main measures SABESP has been adopting since February last year to continue uninterrupted water supply to the São Paulo metro region population despite relevant reduction in water extraction for the reservoirs in the Cantareira system.

To start, we highlight that water production in the Cantareira system in July 2015 over February 2014, when we introduced the measures to reduce consumption fell from 31.77

cubic meters per second to 13.51 cubic meters per second, a contraction of 58%. This means 18.3 cubic meters per second less withdraw since we adopted the consumption reduction measures.

Specifically on the measures, there are four main initiatives we adopted to offset this lower water extraction and at the same time maintain water availability to the metro region of São Paulo. They are, first, the reduction in consumption encouraged by the bonus program responsible for approximately 18.6% of the savings. Second, the water transfers between the São Paulo metro region production systems currently responsible for 40.3% of this reduction. Third, operational maneuvers and investments in reducing water losses accounting for 36.6% on this reduction. And finally, the lower transfer to the Cities of Guarulhos and São Caetano do Sul responsible for 4.5%.

Specifically regarding the bonus program, we point out that the population is maintaining the adherence to the program, and in June and July, the percentage of population that has achieved the reduction was 83%.

In terms of water production for the entire, and that is again the entire metro region, not only the Cantareira, in fact the entire São Paulo metro region, this reduction came to 27% over February last year. In numbers, water production was at 71.4 cubic meters per second at the beginning of 2014 and closed in July this year at 51.9 cubic meters per second.

Let's go to slide 10 and present to you in detail the investments and execution and under development for the period between 2015 and 2017, which are vital to cope with the water crisis and bring more water security to the São Paulo metro region in the short, medium and long terms. The main objective of the investment being executed this year and next year is to increase the reservation capacity of the Guarapiranga and Alto Tietê system, enabling the expansion of the production in these systems and the transfer of more water to the areas originally covered by the Cantareira system. In other words, reduce the dependence on the Cantareira system.

For 2015, there will be an expansion of 6.5 cubic meters per second, led by the interconnection between the Rio Grande and the Alto Tietê system. This investment when completed will transfer four cubic meters of water per second from the former to the later. As a result, more areas currently supplied by the Cantareira system will be able to receive water from the Alto Tietê system. The interconnection is the most relevant project we are carrying out in 2015 and approximately 80% of the work is already concluded, and it should be delivered by the end of September. All in all, in the period between 2015 and 2017, water availability and security will increase by up to 21 cubic meters per sec.

Let's move to slide 10, our last slide where we will discuss the bonus program and the contingency tariffs. As already mentioned, the bonus has been maintaining an average adherence of around 83%, generating savings of 6.5 cubic meters per second in the entire metro region of São Paulo. So this figure is for the entire metro region.

Regarding the contingency tariffs effective as of February 2015 and which objective is not to increase revenues, but to reduce water demand by encouraging the rational use of

water.

Of the total clients, 17% consumed above average in July this year. Considering that 7% of those whose consumption was above average are in the minimum consumption range for social category both not subject to the contingency tariff, only 10% of all consumers actually paid higher tariff this month, the month of July.

As we mentioned in our earnings release, the impact of the bonus on the company's revenue came to R\$231 million in the second quarter of 2015, while that of the contingency tariff totaled R\$123 million. It's important to comment that the funds collected from the contingency tariffs are being used in the emergency work we mentioned before and expenses directly related to the crisis.

Well, those were the remarks, and now we are open for questions.

## Q&A

### Operator

Our first question comes from Carlos Remeika of Covalis Capital (17:29). Please go ahead.

Hello. Thank you for taking my questions. I have a few rather simple ones. I'd like to ask what you expect for tax rate for full-year 2015, given we are making quite a bit of adjustments on a quarterly basis.

And second question, I saw in the second quarter R\$170 (17:55) million decrease in provisions for lawsuits. It's already been better in the Q1. And I was just wondering what would you expect for second half, if it's possible, at least, directionally to say if it still continues to be lower year-on-year. Thank you.

### A - Mário Azevedo de Arruda Sampaio

Okay. Carlos, just a second here. Carlos, it's Mário. Regarding the tax rate for this year, the only thing we can say without giving you more guidance than we usually give is that we will continue working with 34%, okay? No more detail we will give you because again, it's not part of what we do.

On the next, the provisions, what we can say is that there was a big provision, the R\$70 (19:46) million reversal of provision which impacted specifically non-recurring this quarter. And again, we can't comment and we're not - I mean, we don't expect - we're not going to comment for the next quarter. I mean, we can't say that there was a R\$70 million reversal of this only provision, non-recurrent. Okay?

### Q - Operator

Okay. Thank you.

Our next question comes from the Huijun Yang (20:25) of Hummingbird Partners. Please go ahead.

Hi. Thank you for taking my question. So, I have a question about tariff adjustments. I understand there's a back and forth between SABESP and ARSESP on determining adjustments. Could you give us more color on how much leverage SABESP has in determining the adjustment? So what usually causes the difference in weighing inputs between the two parties, for example considering the Q1 difference caused by the Periodo de Compensación. (20:56)

### **A - Mário Azevedo de Arruda Sampaio**

Just a second, Huijun (21:01). Could you repeat the part on the different input, just so we can make sure we understand.

### **Q - Operator**

Sure. So, I was asking what causes the difference in weighing the input between the two parties. For example - and currently I just pulled up the Q1 2015 slides. There is the compensation period.

### **A - Mário Azevedo de Arruda Sampaio**

Okay. Let's get that information to see if we can answer. Just a second. One more second.

Okay. Let me jump in. It's Mário. First, as for the leverage for negotiation, let's put it this way. It's authority, we have a discussion that is very technical. They are very open for the discussions. We open and develop all the discussions on an agenda basis. So the leverage is just as usual as you can see in the electricity sector, although the major company being regulated by the state regulatory agency is SABESP. If I understood the question, this would be the answer.

As for the second point, the difference in input, we understand that there are two issues. First is the deferred implementation of the tariff revision, which should have happened in April last year. And we, SABESP, postponed it to December. So that was deferred, but although deferred, we were granted an adjustment - capitalized adjustment of that tariff implementation. So, ultimately, we implemented a 6.5% increase and not a 5.4%, which was the original number. That is one.

The other was the extraordinary tariff increase, the 15.21%. The difference there is that we asked for compensation for the years of 2013, 2014 which were actual years, plus expected 2015 and 2016, forecasted 2015 and 2016. And ultimately, what the regulator, he recognized to a great extent the 2013 and 2014 and agreed upon the projections on the 2015 and 2016. But he decided to implement only the 2015 and 2016 and the 2013 and 2014 he will add that as a regulatory asset for the next revenue - for the next tariff revision as of April 2017, for the next cycle. Okay?

### **Q - Operator**

I see. So just a quick question on that point, so does that mean that the 2013 and 2014 compensation period then amounts to the 7.02%?

**A - Mário Azevedo de Arruda Sampaio**

No, no. That's the point. What happened this April was the ordinary - the normal tariff adjustment to inflation and the number there was something around 7%. I don't have the - I don't remember the specific number. We're going to get it. So that was just inflation.

The extraordinary tariff increase that we were granted was 6.9%. What we asked for was 13%, and we're getting the detail, I don't have it on the top of my mind, was 13% - [Foreign Language] (26:37) was 13.2%, 13.4%, something like that.

So the difference between what we asked for the extraordinary and what we got from the extraordinary is the deferred 2013 and 2014 revisions. So the 2015 rounding numbers, okay, about 7%, 6.9%, is the actual revision, what was granted to us. And the difference to that is inflation for the period, okay? So what we did not get, we will get it in the next tariff cycle. So it was deferred to the next tariff cycle.

**Q - Operator**

Okay. I got it. Thank you very much.

**A - Mário Azevedo de Arruda Sampaio**

Okay.

**Operator**

Our next question will come from Michael Gaugler of Janney Montgomery Scott. Please go ahead.

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

Hello, everyone.

**A - Mário Azevedo de Arruda Sampaio**

Hi, Michael.

**A - Operator**

Hi, Michael.

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

Just one question. A couple of mine have already been answered. I noticed in the quarter cash fell pretty substantially and wondering what was behind that and if you would anticipate that cash levels will remain about where they were at the end of the second quarter going forward.

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## A - Mário Azevedo de Arruda Sampaio

Okay. Michael, the reason that the cash fell this quarter substantially is basically because we anticipated that we paid down in anticipation a R\$500 million debt that was due in November this year. So we took the decision to anticipate, we prepaid. There was no fee for prepayment. It was already agreed to. So to that extent, we reduced our total debt for the quarter, albeit we did reduce the cash. Probably, no, we won't give you a guidance on where we see the cash flow at the end of the year, but we will come to market and we should, to some extent, replenish our cash availability. So I can't give you the number we are working with, but I can anticipate that we should put a cash availability up from where it is today.

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

Okay. Thanks, everyone.

## A - Mário Azevedo de Arruda Sampaio

Thank you.

## Operator

Our next question comes from (29:41) of ZENA Investment Management. Please go ahead.

Hello. My question is on debt. Given that we've seen some depreciation of the Brazilian real since the quarter-end and there are some forecasts out there that we could get to something like R\$4 per dollar by the end of the year, what are the levers that you have to deal with the impact that this will have on your debt balances and, therefore, your debt covenants to keep you in compliance.

## A - Mário Azevedo de Arruda Sampaio

Okay. Just a second there. (31:03), first, our debt exposure went up to 46.2%. Last quarter, it was 45.8%, and the quarter before that, 40%. So it's actually going up because of the exchange rate against the real as we all know. What are we going to do about it is we're not going to hedge our debt profile, it makes it inadequate to hedge. In addition to that, the hedge would have no effect on our debt covenants the way they are estimated. They do not take into account any hedging. So again, in summary, it is very expensive. It doesn't make sense from a debt profile and the cash flow, and it doesn't affect our debt covenant estimates.

But we are obviously doing a lot. We have been in the process of going after receivables. We're going after - we have been able to increase tariff last December. We're just now in the discussion around an extraordinary tariff increase which has - which will be fully implemented, the 15% on the third quarter. So, we have also done a lot of improvement in our cost structure.



As you can see on the quarter-to-quarter basis, we've been able to reduce cost by 11.2%. So, yes, the covenants will continue fairly stressed, but I think we have many elements in front of us and actions we have taken that we're very well in a position to go over next quarters even if the exchange rate continues pressed as it is right now. Okay?

### **Q - Operator**

Okay. Can I just ask a follow-up on the cost structure? So the cost reductions in the quarter, is that - do you view the run rate, the 11% underlying decline as something that is sustainable as we move through the rest of the year?

### **A - Mário Azevedo de Arruda Sampaio**

Again, that would be - giving you the specific would be giving you a guidance, but what we can see that - tell you that there are further actions we have taken that we expect coming in at some time. So, again, it's hard to say exactly when, but we cannot tell you how much we expect. Okay?

### **Q - Operator**

Thank you.

Our next question comes from Doug Newton of The WindAcre Partnership. Please go ahead.

### **Q - Douglas Newton {BIO 15163101 <GO>}**

Hi. Good afternoon, Mario. The exploration of changes into the tariff structure, what impact might that have on the company's total revenue?

### **A - Mário Azevedo de Arruda Sampaio**

Doug, the effect is neutral. So it's just how we cut the pie and not the size of the pie.

### **Q - Douglas Newton {BIO 15163101 <GO>}**

Got it. Thank you.

### **A - Mário Azevedo de Arruda Sampaio**

Yes.

### **Operator**

At this time, I'm showing no further questions. So now I would like to turn the conference back over to SABESP for their final remarks.

### **A - Mário Azevedo de Arruda Sampaio**

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Okay, everybody thank you once more for participating of this call. And we'll obviously be back next quarter and hope to see you then. Thank you. Bye-bye.

## Operator

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

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