

Q3 2019 Earnings Call

Company Participants

- Benedito Pinto Ferreira Braga Junior, Chief Executive Officer
- Mario Azevedo de Arruda Sampaio, Head of Capital Markets and Investor Relations

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 third 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 slideshow presentation available for download. We inform you that this call is being recorded and that all participants will 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 Benedito Braga, CEO; Rui Affonso, Chief Financial Officer and Investor Relations Officer; Adriano Stringhini, Corporate Management Officer; Mario Arruda Sampaio, Head of Capital Market and Investor Relations; and Marcelo Miyagui, Head of Accounting.

Now, I will turn the conference over to Benedito Braga, CEO. Sir, you may begin your conference.

Benedito Pinto Ferreira Braga Junior {BIO 1918318 <GO>}

Thank you. Good morning, everyone. It is a great pleasure to be in this conference with our directors and superintendents to discuss the results of the third quarter. We are extremely happy with the results. You'll appreciate the results. Mario Sampaio will in a very detailed fashion present the results for you and what I would like to say is that the

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administration of this company is looking forward to bring in more and more consumers and we were very successful in bringing in Guarulhos and Santo Andre that is now producing the earlier results of the assumption of these municipalities. We were very successful in Guarulhos to stop water rationing and more than a million people that were going through rationing are not any longer in that situation. Also the intermittency of water distribution in Santo Andre will be improved and we already started some civil works that is going to be very beneficial to the population of Santo Andre during the summer time, approaching summer time in December, January and February.

So in a nutshell things are moving smoothly. We are very determinant to clean up one of our icons in Sao Paulo, the Pequeno River by 2022 and this involves a lot of investment in sewage collection and treatment but we are prepared for that. We are now using innovative contracting processes that will accelerate results in the area of sewage treatment. This is very important for the image of our company and the interest of our shareholders in these results. So without further ado, I will give the floor to Mario Sampaio to present you in detail the financial results. Thank you.

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

Hey, thank you, Mr.Braga. Let's -- so let's start. Let's start on Slide 3. (Technical Difficulty) including the services now being provided to Guarulhos and Santo Andre, we can see that a sort of build volume increased by 2.8%, of which 2.4% was for water services and 3.4% was for sewage services, when you compare to the third quarter '18. We considered Guarulhos and Santo Andre the total build volume rose to 3.8%. Now on Slide 4, here we will discuss our financial results. For the third quarter of '19, our net income was BRL1.2 billion compared to third quarter '18 net income of BRL565 million resulting in a bottom line growth of 113.9%. This variation is mainly driven on the positive side to the BRL1.3 billion impact due to the recognition of extraordinary revenues from the signing of the agreement with the municipality of Sao Paulo; to recall, this is to provide sanitation services directly to the end users.

On the unfavorable side, the increase in financial expenses resulting from the devaluation of the Brazilian Real against the dollar and the Japanese Yen was the main event. Net operating revenue was BRL5.4 billion against BRL3.8 billion in third quarter of '18 resulting in an increase of 42%. Including the services in Santo Andre, net operating revenue was BRL4.1 billion which corresponds to an increase of 8.5%. As for cost administrative and selling expenses and construction costs, we had an increase of 5.5% mainly due to services, electricity and general expenses. On the other hand, we had a 25% reduction in salaries, charges, benefits and pension obligations accounts, largely due to the reversal of a provision referring to an agreement signed with the Public Prosecutor Office of Sao Paulo regarding the gradual dismissal of retired employees which the company fully complied with the requirements that were established by the state prosecutor. We will further explain this point in the next slide.

Adjusted EBITDA reached BRL3 billion in third quarter '19 increased by 109% or BRL1.6 billion against BRL1.4 billion in the same period of 2018. The adjusted EBITDA margin in the quarter was 55.6% versus 37.6% in the same period of last year with a margin of 44.6% in the last 12 months. If we exclude the effects from construction revenue and construction

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costs, the adjusted EBITDA margin in this quarter would be 64% versus a margin of 46% last quarter '18. As for the last 12 months margin, this quarter we reached 52% compared to 45% in the same period 2018. Move on to Slide 5, on the slide we will highlight the key variations that impacted the results in this quarter. Starting with Santo Andre, in July '19, the company entered into an agreement with the municipality for the operation or beginning of operations in August. Initial impact of this agreement in third quarter of '19 was an increase of BRL1.3 billion on operating revenues and a BRL41.7 million decrease in expenses with the net effect before income tax and social contribution of BRL1.3 billion.

Next event refers to the operation in the City of Guarulhos which had a positive impact this quarter on this quarter results with the recognition of BRL160 million in operating revenues and BRL37 million in costs and expenses and this excludes revenue and construction costs. Results is a net income before income tax and social contribution of BRL78 million in the period. The same accounts for a second quarter '19 were operating revenue of BRL90.6 million cost and expenses, again excluding revenue of construction costs of BRL66.5 million and net income before income tax and social contribution of BRL24 million, all of which expresses an improvement with the operation of Guarulhos.

Moving on, this next -- this quarter we've reversed a provision in the amount of BRL173 million in the salaries, charges and benefits and social security to obligations account due to the termination of the retirement Conduct Adjustment Term, what we call here as TAC, is going back on October 11, 2019, the state prosecutor responsible for the proceeding recognized that the company complied entirely with the requirements and thus concluded the proceeding.

Recall this matter all the way back on February 20, 2009 SABESP and the state prosecutor signed a conduct agreement, the TAC which I mentioned, in which case the company pledged to promote the gradual dismissal of employees already retired. Due to this the company constituted a provision for the dismissal of these employees, (inaudible) remembering at this time the number of employees involved totaled 2250.

Next point, expenses with the partial start of the services rendered by the Sao Lourenco Production System in the third quarter of 2018, had an impact of BRL19.2 million. In the third quarter of '19 the operation was in full capacity resulting in an expense of BRL53.6 million thus generating an impact of BRL34.4 million in the period in our results. Moving forward as last quarter the company has also advanced in the process of adjusting its contract with municipalities where it operated in a contractual lease -- precarious manner. In the sense, the company entered in agreement with the municipality of Guaruja in which it formalizes the contract for the rendering of sanitation services for a period of 30 years and at the same time closed outstanding lawsuits recognizing them as a nonrecurring expense in the amount of BRL46.4 million in the third quarter of '19.

Finally, we highlight the signing of the adhesion agreement with the FUNCESP foundation as we have been observing our healthcare plan managed by SABESPREV was imbalanced due to increasing healthcare costs and demanding thus timely contribution by SABESP in order to maintain the financial solvency and margin requirements established by the National Healthcare Agency known as ANS. In August '19 a new health plan managed by FUNCESP came into force replacing the previous plan. With the signing of this new

healthcare plan, no additional contributions were required and thus the company recorded saving of BRL39.1 million in healthcare expenses this quarter when compared to third quarter of '18.

Let's move now to Slide 6. Here, we will highlight the key variations that impacted our cost in the third quarter of '19. As already mentioned on the previous slide when compared to the same period of last year cost administrative, selling and construction costs increased by BRL148.4 million or 5.5%. Including construction costs, the cost of administrative and selling expenses increased by BRL172 million or 8.6%. The main increases were a BRL141.9 million or 65.5% in general expenses, BRL83.4 million or 22.8% in services and BRL41 million or 17% in electricity expenses. Services, several factors contributed with increase in expenses such as an highlighting expansion of services related to meter reading and delivery of bills and the increase in network maintenance and paving services. Naturally we can highlight the cost resulting from their agreement with Santo Andre related to the permanent of approximately 1,000 employees for 6 months. This represented a BRL6.7 million increase in cost incurred for only one month that is September '19.

(Technical Difficulty) need to remember that the number of employees assigned will drop to 400 starting in the 7th month of the contract signature. General expenses were impacted by non-recurring events such as determination of losses with an impact in Guarulhos, the result of the agreement we entered into as mentioned in the previous slide. We also had an increase in electricity consumption compared to last year third quarter. This is due to the new Guarulhos operations and the startup of two very important investments, the Jaguari-Atibainha Interconnection and the before mentioned Sao Lourenco Production System. On the other hand, we highlight the reversal of provisions for the retirees in the amount of BRL173 million positively impacting the salaries, charges, benefits and pension obligations account. Well for breakdown of these and other charges cost, please refer to our earnings release.

Let's quickly go on to slide 7, here we summarize the variations that affected the company's net income in the third quarter always compared to second quarter -- sorry, third quarter '18. Net income as already mentioned reached BRL1.2 billion, net operating revenue increased BRL1.6 billion, cost and expenses including construction costs increased BRL148 million, other operating income and expenses including equity income had a negative variation of BRL90 million. Financial results had a negative variation of BRL457 million and finalized income tax and social contributions increased BRL331 million due to the higher taxable results in the third quarter of '19.

Let's move on, (Technical Difficulty) case we should be looking slides 8, 9, 10 starting we would like to share with you a brief analysis of 3 management performance indicators namely gross revenue per cubic meter, operating expenses per cubic meter and EBITDA per cubic meter. This analysis, we took a historical series since 2014, using quarterly accounting data disclosed by the company. Additionally, we made some adjustments to isolate some extraordinary and relevant event that would distort the results. Additionally, to look at the performance for the period in the same basis, we brought all values at average prices for the third quarter of '19 updated by the EPCA which is the index used to adjust our inflation on a yearly basis. Our goal with this approach is to look at the company's performance through indicators over a longer period of time and on the same

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price basis than in nominal terms on a quarter-over-quarter basis where a specific event may lead to comparison basis problem as well as impose difficulty in analyzing -- in a better analyzing the company's evolution and performance over time.

As you can see from these 3 slides, gross revenue shows a fairly favorable and consistent evolution regarding operating expenses, it's clear that, it evolves in a controlled manner and compatible with the expansion of our operations in the period as a result of disciplined cost management. Lastly and largely as a result of the behavior of the gross revenue and operating expenses, we see a very consistent growth in EBITDA per cubic meter.

Now let's comment 3 points that we'd like obviously to highlight. One of them, this quarter was the beginning of operations on an emergency basis of Guarulhos sewage treatment services on August 22 following the breach of the agreement between the Municipality of Guarulhos with the PPP Santo Andre operations in September with the objective of assuming 100% of the provision of public sanitation services. In the municipality of Guarulhos, we signed a commitment letter for the preparation of an amendment so the main water is sewage public service agreement with the municipality of Guarulhos which we signed on December, 12 2018. In summary we want to include the sewage treatment service in the main contract. This amendment should be done anytime soon and at the time we will obviously make it public and we will communicate to the market. We remind you that operating 100% of Guarulhos sewage services added with the provision of this same service in Santo Andre both will be a major step in the process of depollution of the GSA water basin (inaudible) River.

Let's also comment on the tariffs structure. As you may be aware in May this year ARSESP disproved resolution number 865 which establishes the schedule of events to be observed in the revision of the company's tariff structure. Part of the schedule, this just now on November 15, the company submitted to ARSESP our proposed tariff structure along with implementation plans.

Next step will be the public consultation process scheduled by ARSESP for April 2020 when the regulator should disclose more details in this matter. Last point, we also like to comment refers to our debt in foreign currency. Today 49.2% of the company's total debt is exposed to the exchange rate variation of the Brazil Real against the U.S. dollar and the Japanese Yen. This is due to its outstanding loans with multilateral banks basically IDB and IBRD, the official Bank of Japan call it JICA but just remember that these funding offer very long-term and low cost and again, we also count with other funding and incremental use of capital and credit markets and overall depth structure.

During the current international and national macroeconomic conditions and their impact on interest and exchange rate and in particularly the significant reduction in the differential between internal and external interest rate, the company should whenever possible contemplate actions to capture opportunities that will result in a decrease in its foreign exchange exposure. The case of debt with the multilateral and official banks, some of our current contract already have a currency exchange clauses that may be amended to include this option in such that there will be no need for the use of market currency hedging instruments or the execution of any debt currency exchange.

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For other debts of the company in foreign markets, whether a private credit or public financing that do not have currency exchange clauses, the company may resort to market currency hedging instruments to reduce the exposure. Company continues to prioritize assets to increasingly diversify credit sources both internal and external to support its investments, its cash and refinancing needs and in this sense, we always evaluate the opportunity to carry out currency hedging operations based on conditions and cost offered by the market.

Well, this concludes our comments or highlights and now we pass on to the Q&A session.

(Question And Answer)

Operator

(Operator Instructions) At this time, we will pause momentarily to assemble our roster.

(Operator Instructions) There appears to be no questions in question queue and I would now like to turn the conference back over to SABESP's for their final remarks.

Benedito Pinto Ferreira Braga Junior {BIO 1918318 <GO>}

Okay, thank you everybody for your time. We will definitely be back here soon for the fourth quarter results and (Technical Difficulty) more. Thanks. Bye-bye.

Operator

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

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