

SABESP

Rationing on thru 2016; keeping Sell with lower estimates and R\$15 PT after meeting water experts

2015 will look like 2014, but 2016 will face some supply constraints too

We cut our 2015-18 EBITDA by 30-7% (Figure 1) based on poor hydrology and low reservoir levels - they are at 12% of capacity (-30pp vs. prior year) and even 100% of average rainfall this year will likely not be good enough to replenish reservoirs to pre-rationing levels. See Figure 6. This means (i) constrained supply thru mid-2016 (-4% in 2015, -2% in 2016); (ii) lower average tariffs for longer (which underscored recent quarterly earnings misses vs. UBSe); (iii) deteriorating outlook for extraordinary tariff hikes in early 2016; (iv) higher scrutiny over the 2017e tariff review given the need for an even greater increase to compensate squeezed profitability in 2014-16 – we assume inflation-based hikes until 2017 and >20% then. In the meantime, we expect below-average dividends due to lower earnings/payout, underscored by: i) low parent needs for cash (the SP State Govt. is cutting dividends from CESP); (ii) limited cash flows to pay for additional capex required to increase supply; (iii) high leverage (>4x EBITDA).

Meeting the water experts and looking closely into co.'s reservoirs situation

We learned three things this week: (1) 2016 will remain challenging: even 110% of historical rainfall (vs. <50% for now) would require some demand-side management. Our 2015e EBITDA is in line with consensus but 2016e is 19% below consensus estimate; (2) SABESP will need federal agency ANA's blessing to add water supply in three cases: i) usage of even more void volume from Cantareira, ii) renewal of water licenses, iii) integration of river basins; (3) poor hydrology also in Rio and south of Minas states might constrain supply additions from the new SABESP projects. See Figure 8.

Key driver: hydrology/tariffs. R\$20 Upside and R\$9 Downside cases (see pg. 2)

We cut our PT by 25% to R\$15/sh on lower estimates and 100bps higher discount rate (the latter reflects uncertain tariff hikes to compensate for hydrology-rated losses).

Valuation: lower SOTP/DCF-based R\$15 PT (10% Ke in real R\$); reiterate Sell

We prefer to Bz electricity discos on better contractual protection against rationing.

Equities

Americas
Water Utilities

12-month rating **Sell**

12m price target **R\$15.00**
Prior: **R\$20.00**

Price **R\$15.49**

RIC: SBSP3.SA BBG: SBSP3 BZ

Trading data and key metrics

52-wk range	R\$24.56-15.10
Market cap.	R\$10.6bn/US\$4.07bn
Shares o/s	684m (PREF)
Free float	50%
Avg. daily volume ('000)	1,348
Avg. daily value (m)	R\$24.1
Common s/h equity (12/14E)	R\$13.6bn
P/BV (12/14E)	0.8x
Net debt / EBITDA (12/14E)	3.0x

EPS (UBS, diluted) (R\$)

	From	To	% ch	Cons.
12/14E	1.17	1.39	19.00	1.67
12/15E	2.58	1.34	-48.18	2.05
12/16E	3.33	1.70	-48.89	2.71

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Highlights (R\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Revenues	9,942	10,738	11,316	11,219	11,943	12,478	13,776	15,741
EBIT (UBS)	2,354	2,850	3,136	2,030	1,945	2,395	3,526	5,011
Net earnings (UBS)	1,223	1,919	1,924	953	913	1,162	2,044	3,086
EPS (UBS, diluted) (R\$)	1.79	2.81	2.81	1.39	1.34	1.70	2.99	4.52
DPS (R\$)	0.85	0.78	0.79	0.42	0.40	0.51	1.20	1.81
Net (debt) / cash	(6,694)	(7,374)	(8,125)	(8,986)	(10,059)	(10,774)	(10,806)	(10,035)
Profitability/valuation	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
EBIT margin %	23.7	26.5	27.7	18.1	16.3	19.2	25.6	31.8
ROIC (EBIT) %	12.6	14.1	14.1	8.4	7.5	8.6	12.0	16.3
EV/EBITDA (core) x	6.1	7.4	6.9	7.1	7.5	6.4	4.9	3.9
P/E (UBS, diluted) x	8.5	9.0	9.2	11.1	11.6	9.1	5.2	3.4
Equity FCF (UBS) yield %	1.2	3.0	2.5	0.2	(3.3)	2.3	10.6	19.7
Net dividend yield %	5.6	3.1	3.1	2.7	2.6	3.3	7.7	11.7

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of R\$15.49 on 21 Jan 2015 18:42 EST

Investment Thesis

SABESP

Investment case

We rate SABESP Sell as we think the stock price does not yet reflect continued margin squeeze from poor hydrology vs. a not-yet-set-in-stone tariff reset methodology. Lack of visibility will likely weigh on the stock until we see the state regulatory agency ARSESP and parent Sao Paulo State Government incorporate rationing-related costs (foregone revenues, opex pressure and higher capex to fight supply shortage risks) to the 2017 tariff reset process in its concept. Under this scenario (note that we assume the R\$330m p.a. pass-thru to final consumers of the São Paulo city contract cost happening in 2016), balance sheet will be under pressure and we believe top management will not increase payout and dividends until they get some reassurance of tariff hikes/earnings recovery.

Upside scenario

R\$20/sh implied fair valuation - In the upside scenario we assume good rainfall in 2015 at 110% of the long term average – this should rule out supply constraints so that demand can be normalized in year 2016. Moreover, we also assume that the ARSESP agency will audit SABESP's calculated regulatory asset base and remunerate 50% of R\$7bn in past capex – this would add R\$3/sh to our Base Case. Finally, we see R\$2/sh Upside with the recovery of >R\$1.3bn that was already paid to the São Paulo city (3Q10 until now) and that has not yet been recognized in the tariff.

Downside scenario

R\$9/sh implied fair valuation - We assume (i) continued poor rainfall in 2015 at 90% of the long term average that will extend the margin squeeze thru beyond 2016; (ii) ARSESP agency will audit SABESP's calculated regulatory asset base and still leave out the disputed R\$7bn in past capex: this means -R\$3/sh downside; (iii) no pass-thru of the São Paulo city contract cost (R\$330m p.a.) to end-users – the latter translates into -R\$3/sh.

Upcoming catalysts

- Poor hydrology in the rainy season (Nov. 2014 – Apr. 2015).
- Inflation-based tariff adjustments (April).
- 4Q14 results and new capex guidance.
- Pass-thru of Sao Paulo city contract costs.
- Compensation outlook for drought-related losses.

12-month rating

Sell

12m price target

R\$15.00

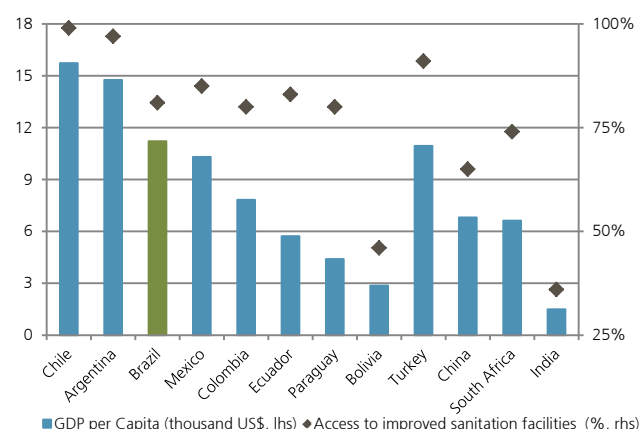
Business description

São Paulo state-controlled SABESP is South America's largest water utility, serving 24m people via 7.7m water connections (100% service penetration in its concession area), 6.1m sewage connections (83% penetration) and 76% sewage treatment (set to grow to 93% by 2019 as per recent capex plans). Despite 2007 federal water legislation and 2008 definition of ARSESP as its state regulatory agency, uncertainty on the tariff framework looms. Company's first five-year rate review of 2012 was delayed and remains controversial (namely on regulatory asset base and volume risks).

Industry outlook

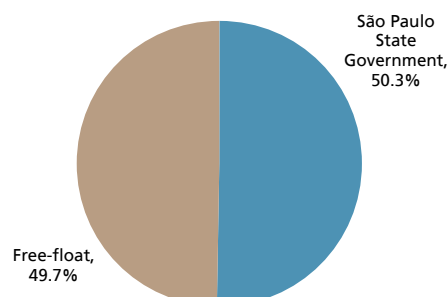
Brazil also ranks poorly in terms of service penetration vs. other LatAm and emerging countries with only 63% of Brazil's houses with access to sewage network and 85% with access to drinking water supply (IBGE, 2013). However, high volume growth upside can be offset by very poor tariff frameworks underscored by state-ownership, mostly inefficient management and historically challenging political and macroeconomic conditions.

Access to sanitation vs. GDP per capita



Source: UBS, World Bank (2013 GDP/capita; 2012 sanitation data).

Ownership structure (as of 3Q14)



Source: Bloomberg, Company data, UBS.

Summary and Analysis

Our estimates are down substantially for 2015-19 (Figure 1) on supply constraints and our assumption that company will only be c.70% compensated for rationing-related losses. We are assuming 3% lower volumes in 2015 vs. 2014, -1% volume growth in 2016, 5% in 2017 and 2% thereafter. As for tariffs, we assume inflation-based adjustments in 2015 and 2016 and a stronger c.21% tariff hike in 2017e due to company's second rate review process. On the cost side we assume opex to grow slightly above-inflation, spending to remain flat vs. original capex budget (but with greater focus towards water supply capacity as opposed to sewage collection/treatment), and higher interest expense from lower cash flows/higher leverage. Despite a controversial and still disputed 2012 rate review, our model assumes that SABESP gets a 21.2% tariff hike in 2017 based on 8.1% ROA over existing capex plans.

With a still poor tariff framework and state-ownership, we are sceptical of above-inflation hikes before 2017.

While one could argue that lower revenues/higher costs could be offset by much higher tariffs in the future, we believe investors should not pay for this upfront given: (i) the not yet set in stone rate review methodology (the next review over co.'s overall profitability is set for April 2017 and regulatory provisions allow for extraordinary tariff reviews within up to 180 days *after force majeure* events); (ii) chances that the review methodology will somewhat still partially blame SABESP for the hydrology-related loss of profitability; (iii) regulatory developments have been disappointing (regulatory asset base dispute in the 2012 tariff review, no pass-thru of costs from the Sao Paulo city contract, signed 5 years ago; (iv) our contrarian view that demand-side management initiatives will likely be extended thru 2016YE given the deep-low reservoir levels today.

Figure 1: Lower 2015-16e EPS/FCFE reflect supply constraints and inflation-only tariff hikes – we do not assume an extraordinary tariff review that could make SABESP whole for hydrology-related losses (lower revenues, higher costs)

R\$ million – except for EPS and DPS in R\$/sh

NEW	2015e	2016e	2017e	2018e	2019e	Comments
Net Revenues	11,943	12,478	13,775	15,738	16,666	Tariff reset in 2017e with a 21% tariff hike and inflation-based adjustments until then.
EBITDA	3,029	3,541	4,735	6,284	6,669	
Net Income	913	1,162	2,044	3,084	3,178	Company should increase leverage/erode its relatively high R\$1.9bn cash position of Sep 2014.
FCFF	-347	244	1,120	2,080	2,272	
FCFE	-902	-346	506	1,515	1,847	
OLD	2015e	2016e	2017e	2018e	2019e	Comments
Net Revenues	13,458	14,314	15,652	17,499	18,353	Our prior model assumed normalization of hydrology in 2015.
EBITDA	4,306	4,890	5,635	6,758	7,142	
Net Income	1,762	2,274	2,794	3,506	3,795	
FCFF	524	1,076	825	1,689	1,864	
FCFE	-79	628	415	1,266	1,522	
CHANGE	2015e	2016e	2017e	2018e	2019e	Comments
Net Revenues	-10%	-13%	-8%	-4%	-4%	We are sceptical that company will be fully compensated for foregone revenues/higher costs from poor weather.
EBITDA	-30%	-28%	-16%	-7%	-7%	
Net Income	-48%	-49%	-27%	-12%	-10%	
FCFF	n.m.	-77%	36%	23%	22%	
FCFE	n.m.	n.m.	22%	20%	21%	

Source: UBS estimates

UBS estimates are well below consensus for 2015-16e, and more so for year 2016 (Figure 2). Our negative view follows recent meetings with experts and our analysis of current reservoir situation for SABESP, also taking into account new projects that could add >20% capacity for piped water over the coming three years. We believe there is considerable risk of much lower volumes in 2015 from poor hydrology. Rainfall is estimated to be 44% for the SE/CW region for January 2015 ([click here for our updated slides on Brazilian Utilities – 2015 Outlook "Déjà vu? Rationing Series 3"](#)) and weather visibility for February and March remains very low. Another year of poor hydrology would mean limited supply for 2016.

Figure 2: UBS is in line with consensus for 2015 but we see downside risks to our estimates for the year. Moreover, UBS has a contrarian, negative view for 2016 vs. consensus estimates

In nominal R\$ million

	2015e (8 contributions)			2016e (6 contributions)			2017e (2 contributions)		
	UBSe	Consensus	UBSe vs. Cons.	UBSe	Consensus	UBSe vs. Cons.	UBSe	Consensus	UBSe vs. Cons.
EBITDA	3,029	3,122	-3%	3,541	4,379	-19%	4,735	4,908	-4%
Net Income	913	1,268	-28%	1,162	1,749	-34%	2,044	1,986	3%

Source: Bloomberg, UBS estimates

The recent (and positive, in our view) changes at SABESP's CEO and Chairman posts underscore the parent Sao Paulo State Government's views that the company will need to work closer to federal water agency ANA to address supply constraints. In 2014 we saw the debate on lack of planning to fight water scarcity turn into press headlines ahead of the nationwide elections. We expect the discussion over hydro resources and their usage to be much more technical going forward. Both new SABESP executives, CEO Kelman and Chairman Braga Junior, have ample experience in hydro resources and sanitation services. Finding ways to increase water supply capacity and avoid stronger shortage is (and should indeed be) company's priority, in our view. Profitability and dividends are secondary issues that will likely be discussed in 2017. A civil engineer, Chairman Benedito Braga Jr. is a professor at University of Sao Paulo, holds a master in Hydraulic Engineering and a Ph.D. in hydrology from Stanford University. He is the president of the World Water Council (WWC) and of the International Forum Committee. Formerly he has already been president of the International Hydraulic Program of UNESCO, a Board member of water regulatory agency ANA (from its creation in 2001 thru 2009) and president of Water Resources Association (IWRA). Also a civil engineer, CEO Jerson Kelman is a professor at Rio de Janeiro Federal University and holds a Ph.D. in water resources from Colorado State University. Previously Kelman was CEO of electric utility Light (2010-2012), head of electricity regulatory agency ANEEL (2005-2008) and head of the water federal agency ANA (2000-2005). Kelman was also a member of the CMSE - monitoring committee of the electricity sector (2005-2008) and of CNPE - national council for energy policy (2003-2005).

SABESP looks expensive on a DCF and dividend yield basis. Our SOTP/DCF-based PT (9.8% cost of equity in real R\$ terms) is down substantially by 25% to R\$15/sh from R\$20/sh. We acknowledge DCF valuation has several caveats, but we particularly like it in view of lack of peer comparables. Regardless, note that our R\$15/sh fair value calculation is mostly concentrated in the long-run (as free cash flow to equity should be negative thru 2016 or until the poor hydrology conditions prevail – see Figure 1). This underscores our negative view on the stock. Moreover, SABESP looks expensive on a dividend yield basis (Figure 3 - [Please click here for our most recent valuation sheets for more than 20 Brazilian utilities stocks](#)).

Figure 3: SABESP valuation multiples looks expensive on an absolute and relative basis

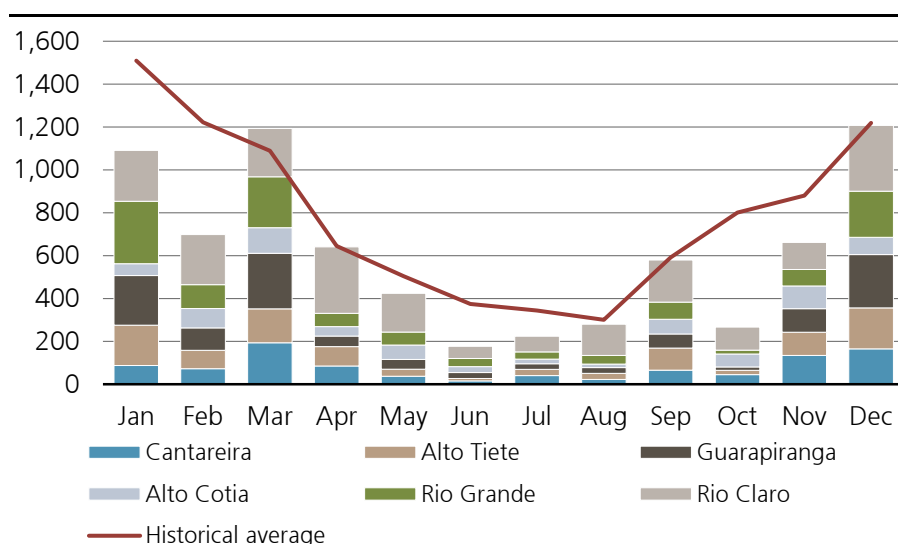
Company	Local Ticker	UBS Rating	Price 21-Jan-15	Price Target	15e	P/E 16e	17e	15e	EV/EBITDA 16e	17e	15e	Div Yield 16e	17e
AES Tiete ON	GETI3	Buy	13.6	19.0	6.7	10.2	9.1	4.3	5.7	5.4	15.5%	10.6%	11.7%
AES Tiete PN	GETI4	Neutral	17.0	19.0	8.3	12.7	11.3	5.2	6.9	6.5	13.7%	9.3%	10.3%
Cemig PN	CMIG4	Sell	11.8	13.0	5.9	5.9	5.6	4.5	4.7	4.7	8.5%	8.5%	9.0%
CESP	CESP6	Sell	24.3	25.0	6.5	19.3	17.2	4.2	n.m.	12.9	7.5%	4.7%	4.7%
Copasa	CSMG3	Sell	22.4	24.0	5.7	5.0	4.3	4.5	4.1	3.7	5.8%	6.5%	7.6%
Copel PN	CPLE6	Neutral	32.0	36.0	5.6	5.9	5.2	4.7	5.0	4.5	9.3%	8.9%	10.2%
CPFL Energia	CPFE3	Buy	17.8	20.0	15.5	11.8	11.4	7.5	6.5	6.3	6.1%	8.1%	8.4%
Cleop	TRPL4	Neutral	38.5	44.0	12.6	10.3	10.3	4.5	4.1	3.9	4.0%	4.4%	4.6%
Eletrobras ON	ELET3	Not Rated	5.4	n.a.	28.3	6.2	n.m.	19.0	9.4	n.m.	0.0%	0.0%	n.a.
Eletrobras PNb	ELET6	Not Rated	7.1	n.a.	37.0	8.2	n.m.	20.9	10.3	n.m.	14.1%	9.6%	n.a.
Eletropaulo	ELPL4	Sell	7.9	7.0	3.6	5.0	3.1	5.1	5.9	4.7	7.2%	5.2%	8.2%
Energias do Brasil	ENBR3	Buy	8.9	12.0	7.0	6.8	5.8	4.0	4.3	3.7	8.6%	8.8%	10.4%
Eneva	ENEV3	Not Rated	0.4	-	n.m.	1.8	1.0	10.6	6.4	5.4	0.0%	13.6%	25.7%
Equatorial	EQTL3	Sell	26.0	23.0	16.1	9.3	9.5	10.0	6.8	6.9	1.6%	2.7%	2.6%
IEI Nova	IEI NOVA	Neutral	71.2	83.0	28.4	25.9	22.3	12.8	11.1	9.7	3.1%	3.2%	3.4%
Light	LIGT3	Neutral	14.8	22.0	5.7	4.0	3.6	5.3	4.3	4.2	8.8%	12.4%	14.0%
Sabesp	SBSP3	Sell	15.5	15.0	11.6	9.1	5.2	6.9	5.9	4.4	2.6%	3.3%	7.7%
Tractebel Energia	TBLE3	Sell	32.3	32.0	12.4	10.7	9.8	7.0	6.3	5.9	8.0%	9.3%	10.2%

Source: Bloomberg and UBS estimates; Bloomberg consensus data used for Not Rated companies

It did not rain enough last year (Figure 4), it is not raining now. 2015 rainfall to-date has been low at 37% of long-term average and in 2014 it only rained 79% of the historical average. We understand that 2014 was the driest of the past 32 years for Cantareira. More importantly, 2015 seems to be looking like 2014.

Figure 4: Below-average rainfall on SABESP's main reservoir systems in 2014

Millimeters of rain

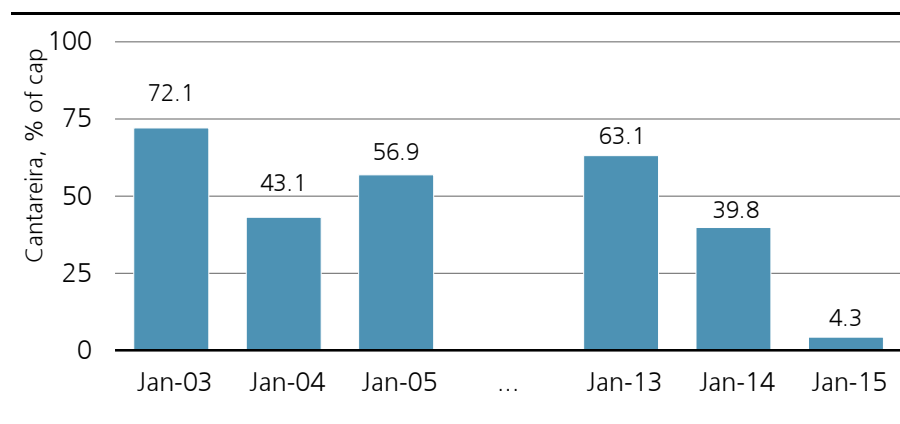


Source: Company data and UBS calculations

As a result, SABESP has very low reserves today and hence is highly dependent on rainfall thru May to normalize supply (Figures 5, 6). Cantareira (65% of SABESP's total reservoir capacity) has only 10 days of water consumption left until SABESP has to ask for the Sao Paulo state water agency DAEE's authorization to use the remaining void volume left at the reservoir (Figure 5). SABESP has already been using water from other reservoirs (Alto Tiete, Guarapiranga, Alto Cotia, Rio Grande, and Rio Claro) to supply Cantareira customers.

Figure 5: SABESP's Cantareira is at <5% of capacity, and already using 290bn of void volume on an emergency basis

Full capacity includes 1,490bn liters

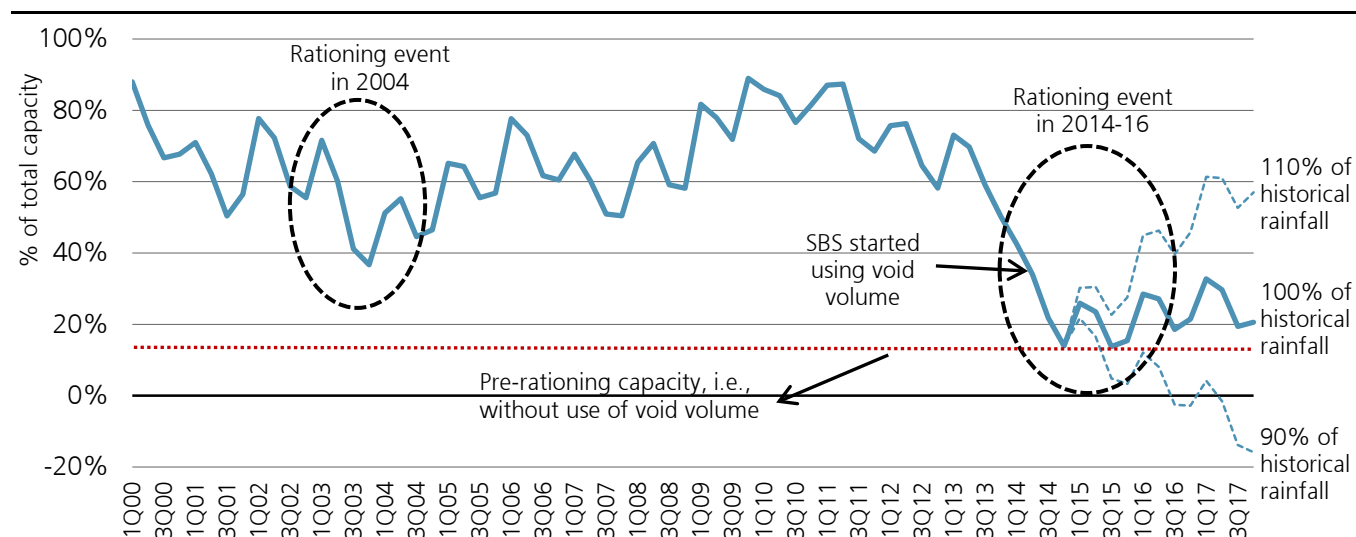


Source: Company data and UBS calculations

The situation is worse than we anticipated, and outlook is indeed highly sensitive to (unpredictable) rainfall in the coming weeks (1Q usually concentrates 35% of the annual rainfall). Rainfall on top of SABESP reservoirs were at 33-75-99% of the historical average in Oct-Nov-Dec, and in the first 20 days of January it has rained 37% of the average. While weather remains unpredictable for the coming weeks and months, the situation seems critical because even if it rains 100% of the average of the past 15 years, this will likely be only enough to bring water reserves to pre-rationing levels. See Figure 6 for details.

Figure 6: Aggregate reservoir levels for SABESP are record-low at c.12% - what if it does not rain?

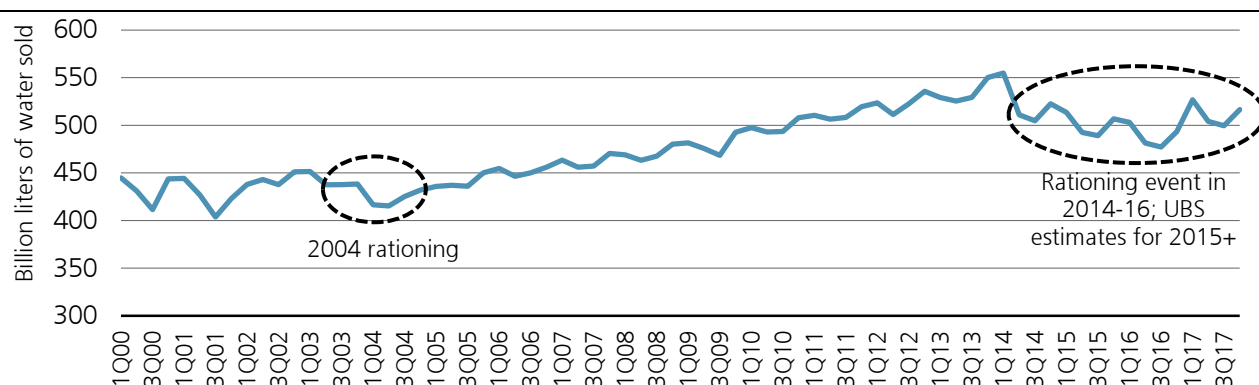
Reservoir levels including dead volume with authorized use by the federal water regulatory agency ANA and state water agency DAEE. Includes Cantareira, Alto Tiete, Guarapiranga, Alto Cotia, Rio Grande, and Rio Claro. Total 100% of capacity is equivalent to 10 months of supply



Source: UBS calculations based on SABESP, ANA and DAEE data

Our views on future water reserves is based on volume reduction for 2015, at -3%. However, temperatures in Sao Paulo have been record-high this summer and hence demand might not drop by as much as expected.

Figure 7: Demand for water from SABESP is a function of supply, population and GDP growth, temperatures, losses



Source: Company data and UBS estimates

Supply-side initiatives require strong investments, and results take time to pay off (Figure 8). Apart from discussing profitability of these investments (arguably all included in company's regulatory asset base in 2017e, and yielding an 8.06% regulatory ROA), we note that capacity additions will be relatively limited in the very near-term. Moreover, we see risks of delayed start-up of new projects. Details below.

Figure 8: Supply-side management initiatives: sewage treatment facilities, water basin integration, new reservoir system to add >20% by 2017

Project	Capex, R\$bn	Timing	Volume Addition m³/s	% of 2013 capacity	Comments
Sao Lourenço System	2.6	2017YE-early 2018	4.7	6.7%	Public-private partnership (PPP) with construction companies Camargo Correa and Andrade Gutierrez. Nil equity investment by SABESP.
Paraíba do Sul basin/Cantareira system integration	0.9	2016YE	5.1	7.3%	Capex was originally R\$500m, then R\$800m as per Oct. 2014 meeting with company, and now R\$930m as per 3Q14 earnings call. Higher capex is explained by the fact that water can flow both ways. This is not yet included in co.'s capex budget – it is not clear who will pay for this investment yet. Federal water regulatory agency ANA has just approved the project, which uses water from federal river Jaguari (Paraíba do Sul basin). Further regulations will be necessary before transposing water from one basin to another. Note that Paraíba do Sul supplies water for Rio de Janeiro cities.
Rio Pequeno river/Rio Grande reservoir (Bilings) integration	0.5	2015YE	2.2	3.1%	Both are in the Sao Paulo state area. Company has not yet detailed the project, but confirmed in November that this will be built.
Sewage treatment to produce reuse water in Guarapiranga	0.3	2015YE	2	2.9%	
Sewage treatment to produce reuse water in Baixo Cotia	0.3	2015YE	1	1.4%	
SUM	4.6		15	21.4%	Up to R\$2bn to be disbursed by SABESP (R\$2.6bn in PPP)

Source: Valor Newspaper quoting Sao Paulo state governor Alckmin, Company, UBS

Demand-side management initiatives started in February 2014 with tariff discounts but were expanded to included tariff surcharges (Figure 9) as consumption have declined by less than company's expectations. Record-high temperatures have fuelled consumption for water and electricity. To illustrate, this month Brazil saw average peak demand in the SE area, and this Monday we saw Brazil's national dispatch administrator cut 5% of electricity supply so as to avoid a collapse in the system of greater impact.

Figure 9: Demand-side management initiatives: tariff surcharges were proposed in Dec. 2014, aiming to reduce consumption by c.5%

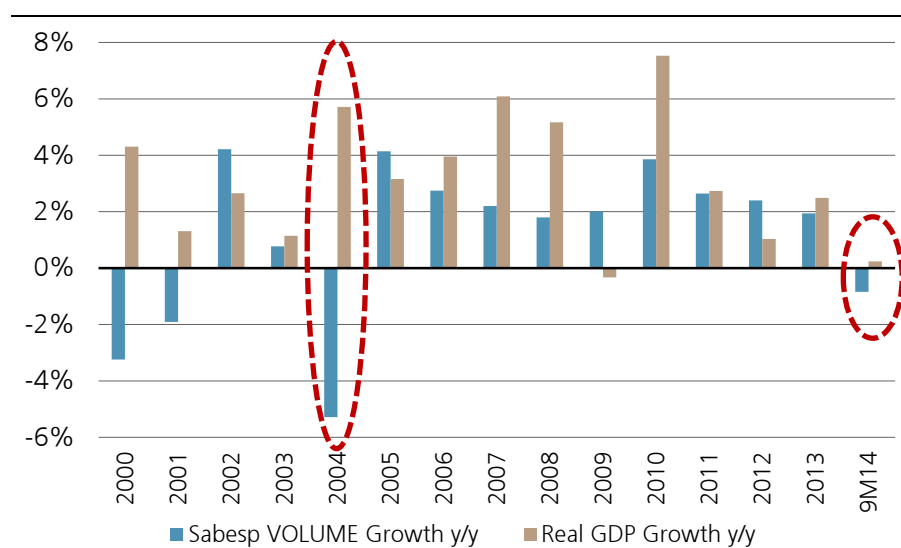
Threshold is each customers average volume consumed from Feb 2013 thru Jan 2014

Tariff incentives	Who is impacted by tariff incentives?	Effective since when?
100% surcharge	For volumes that exceed 120% of threshold volume	Jan-15
40% surcharge	For volumes between 100% to 120% of threshold volume	Jan-15
20% discount	For customers who cut 15-20% of volumes	Nov-14
10% discount	For customers who cut 10-15% of volumes	Nov-14
30% discount	For customers who cut above 20% of volumes	end of Jan-14

Source: Company, UBS

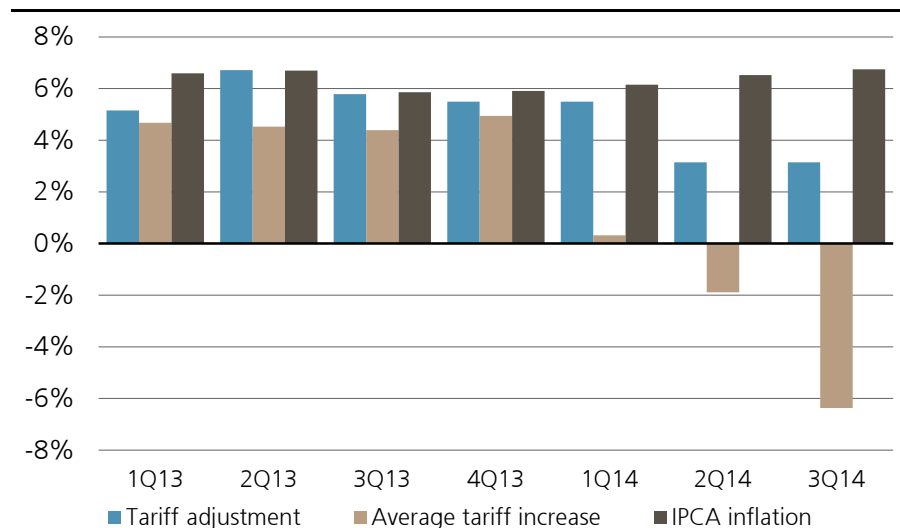
Why give tariff discounts?... We believe the motivation is somewhat political given the low demand elasticity to prices (Figure 10). Moreover, increasing (as opposed to lowering) tariffs in our view is a greater incentive for demand reduction. We also note that reduced water pressure leads to lower volumes and higher tariff discounts – an unnecessary prize to consumers that unwillingly reduced consumption. Note that lower volumes already mean lower tariffs for customers, given that tariffs are progressive: the higher the consumption, the higher the tariff on a R\$/m³ volume basis.

Figure 10: Demand savings campaign via tariff discount policy (initiated in Mar. 2014) has led to a 5.3%-only decline in volumes in 2004 vs. previous year, given high abnormally high temperatures and demand inelasticity



Source: Company data and UBS calculations

Figure 11: SABESP's average tariffs go up by less than the tariff adjustment due to lower marginal volume per customer and co.'s progressive tariff structure. The average tariff since 1Q14 has come down significantly due to tariff discount policy



Source: Company data and UBS calculations

We wonder if rationing-related losses will be compensated with future tariff increases when the 2012 reset came out below expectations. See Figure 12 for recent tariff change history.

Figure 12: The Sep. 2012 tariff reset results came out in pills thru 2014 and was below SABESP and market expectations

	Tariff hike	Comments
Dec 27th, 2014	6.5%	Final tariff reset increase - click here for details. Note that the RAB dispute is still on
April 2014	5.4%	Granted by regulatory agency ARSESP but not implemented by SABESP.
Dec 11th, 2013	3.14%	Delayed implementation of the preliminary tariff reset, originally set for Sep 2012. There was no retroactive implementation, though. Click here for details
Mar 22nd, 2013	2.35%	Preliminary tariff reset increase - click here for details
Sep 11th, 2012	5.15%	Annual tariff adjustment
From 2005 to 2011	inflation	Company has historically increased tariffs once per year in line with inflation, except for year 2004

Source: Company, UBS

SABESP (SBSP3.SA)

Income statement (R\$m)	12/11	12/12	12/13	12/14E	% ch	12/15E	% ch	12/16E	12/17E	12/18E
Revenues	9,942	10,738	11,316	11,219	-0.9	11,943	6.4	12,478	13,776	15,741
Gross profit	4,935	5,468	5,878	4,996	-15.0	5,172	3.5	5,808	7,040	8,743
EBITDA (UBS)	3,123	3,588	4,007	3,045	-24.0	3,029	-0.5	3,542	4,736	6,287
Depreciation & amortisation	(769)	(738)	(871)	(1,014)	16.5	(1,084)	6.8	(1,146)	(1,210)	(1,276)
EBIT (UBS)	2,354	2,850	3,136	2,030	-35.3	1,945	-4.2	2,395	3,526	5,011
Associates & investment income	0	0	0	0	-	0	-	0	0	0
Other non-operating income	0	0	2	(1)	-	0	-	0	0	0
Net interest	(634)	(296)	(483)	(691)	-43.0	(663)	4.0	(764)	(726)	(674)
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	1,721	2,554	2,656	1,338	-49.6	1,282	-4.2	1,631	2,801	4,337
Tax	(497)	(636)	(732)	(385)	47.4	(368)	4.3	(469)	(756)	(1,251)
Profit after tax	1,223	1,919	1,924	953	-50.5	913	-4.2	1,162	2,044	3,086
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	0	0	0	0	-	0	-	0	0	0
Extraordinary items	0	0	0	0	-	0	-	0	0	0
Net earnings (local GAAP)	1,223	1,919	1,924	953	-50.5	913	-4.2	1,162	2,044	3,086
Net earnings (UBS)	1,223	1,919	1,924	953	-50.5	913	-4.2	1,162	2,044	3,086
Tax rate (%)	28.9	24.9	27.6	28.8	4.4	28.8	-0.1	28.8	27.0	28.8
Per share (R\$)	12/11	12/12	12/13	12/14E	% ch	12/15E	% ch	12/16E	12/17E	12/18E
EPS (UBS, diluted)	1.79	2.81	2.81	1.39	-50.5	1.34	-4.2	1.70	2.99	4.52
EPS (local GAAP, diluted)	1.79	2.81	2.81	1.39	-50.5	1.34	-4.2	1.70	2.99	4.52
EPS (UBS, basic)	1.79	2.81	2.81	1.39	-50.5	1.34	-4.2	1.70	2.99	4.52
Net DPS (R\$)	0.85	0.78	0.79	0.42	-46.8	0.40	-4.2	0.51	1.20	1.81
Cash EPS (UBS, diluted)*	2.91	3.89	4.09	2.88	-29.6	2.92	1.5	3.38	4.76	6.38
Book value per share	15.43	16.47	18.92	19.89	5.2	20.83	4.7	22.02	23.81	26.52
Average shares (diluted)	683.53	683.53	683.52	683.52	0.0	683.52	0.0	683.52	683.52	683.52
Balance sheet (R\$m)	12/11	12/12	12/13	12/14E	% ch	12/15E	% ch	12/16E	12/17E	12/18E
Cash and equivalents	2,150	1,916	1,782	1,419	-20.4	1,260	-11.2	230	408	1,368
Other current assets	1,576	1,415	1,472	1,461	-0.8	1,530	4.8	1,581	1,711	1,911
Total current assets	3,726	3,331	3,254	2,880	-11.5	2,791	-3.1	1,811	2,119	3,279
Net tangible fixed assets	20,551	22,218	24,100	25,727	6.8	27,587	7.2	29,223	30,759	32,266
Net intangible fixed assets	0	0	0	0	-	0	-	0	0	0
Investments / other assets	938	927	920	908	-1.3	944	4.0	970	1,038	1,145
Total assets	25,215	26,476	28,274	29,515	4.4	31,322	6.1	32,003	33,916	36,690
Trade payables & other ST liabilities	2,091	2,001	1,874	1,852	-1.2	1,927	4.0	1,980	2,123	2,346
Short term debt	1,877	1,757	1,098	784	-28.61	778	-0.76	815	1,050	1,258
Total current liabilities	3,969	3,758	2,972	2,636	-11.3	2,705	2.6	2,795	3,173	3,604
Long term debt	6,966	7,533	8,809	9,622	9.2	10,541	9.6	10,189	10,165	10,145
Other long term liabilities	3,734	3,928	3,562	3,660	2.8	3,839	4.9	3,969	4,301	4,812
Preferred shares	0	0	0	0	-	0	-	0	0	0
Total liabilities (incl pref shares)	14,669	15,219	15,343	15,918	3.7	17,085	7.3	16,953	17,639	18,561
Common s/h equity	10,546	11,257	12,931	13,598	5.2	14,237	4.7	15,050	16,277	18,129
Minority interests	0	0	0	0	-	0	-	0	0	0
Total liabilities & equity	25,215	26,476	28,274	29,515	4.4	31,322	6.1	32,003	33,916	36,690
Cash flow (R\$m)	12/11	12/12	12/13	12/14E	% ch	12/15E	% ch	12/16E	12/17E	12/18E
Net income (before pref divs)	1,223	1,919	1,924	953	-50.5	913	-4.2	1,162	2,044	3,086
Depreciation & amortisation	769	739	871	1,014	16.5	1,084	6.8	1,146	1,210	1,276
Net change in working capital	(60)	92	(125)	4	-	(63)	-	(47)	(113)	(171)
Other operating	634	296	481	692	44.0	663	-4.2	764	726	674
Operating cash flow	2,566	3,045	3,150	2,664	-15.5	2,597	-2.5	3,026	3,866	4,865
Tangible capital expenditure	(2,440)	(2,536)	(2,716)	(2,642)	2.7	(2,944)	-11.4	(2,782)	(2,746)	(2,783)
Intangible capital expenditure	0	0	0	0	-	0	-	0	0	0
Net (acquisitions) / disposals	0	0	0	0	-	0	-	0	0	0
Other investing	0	0	0	0	-	0	-	0	0	0
Investing cash flow	(2,440)	(2,536)	(2,716)	(2,642)	2.7	(2,944)	-11.4	(2,782)	(2,746)	(2,783)
Equity dividends paid	(579)	(534)	(537)	(286)	46.8	(274)	4.2	(349)	(818)	(1,234)
Share issues / (buybacks)	0	0	0	0	-	0	-	0	0	0
Other financing	(397)	(51)	(266)	(362)	-35.90	(108)	70.06	(175)	(112)	(109)
Change in debt & pref shares	332	279	575	812	41.34	919	13.17	(352)	(24)	(20)
Financing cash flow	(644)	(306)	(229)	164	-	537	226.5	(875)	(954)	(1,363)
Cash flow inc/(dec) in cash	(518)	204	205	186	-9.4	191	2.5	(631)	167	719
FX / non cash items	679	(438)	(339)	(549)	-61.8	(350)	36.3	(399)	11	241
Balance sheet inc/(dec) in cash	161	(234)	(134)	(363)	-170.9	(159)	56.2	(1,030)	178	960

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.*Cash EPS (UBS, diluted) is calculated using UBS net income adding back depreciation and amortization.

SABESP (SBSP3.SA)

Valuation (x)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
P/E (local GAAP, diluted)	8.5	9.0	9.2	11.1	11.6	9.1	5.2	3.4
P/E (UBS, diluted)	8.5	9.0	9.2	11.1	11.6	9.1	5.2	3.4
P/CEPS	5.2	6.5	6.3	5.4	5.3	4.6	3.3	2.4
Equity FCF (UBS) yield %	1.2	3.0	2.5	0.2	(3.3)	2.3	10.6	19.7
Net dividend yield (%)	5.6	3.1	3.1	2.7	2.6	3.3	7.7	11.7
P/BV x	1.0	1.5	1.4	0.8	0.7	0.7	0.7	0.6
EV/revenues (core)	1.9	2.5	2.5	1.9	1.9	1.8	1.7	1.5
EV/EBITDA (core)	6.1	7.4	6.9	7.1	7.5	6.4	4.9	3.9
EV/EBIT (core)	8.1	9.3	8.9	10.6	11.6	9.5	6.5	4.8
EV/OpFCF (core)	8.1	9.3	8.9	10.6	11.6	9.5	6.5	4.8
EV/op. invested capital	1.0	1.3	1.2	0.9	0.9	0.8	0.8	0.8
Enterprise value (R\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Market cap.	10,408	17,257	17,615	10,588	10,588	10,588	10,588	10,588
Net debt (cash)	6,662	7,034	7,749	8,556	9,523	9,523	9,523	10,421
Buy out of minorities	0	0	0	0	0	0	0	0
Pension provisions/other	1,927	2,322	2,460	2,385	2,522	2,659	2,859	3,214
Total enterprise value	18,997	26,612	27,824	21,529	22,632	22,770	22,969	24,223
Non core assets	0	0	0	0	0	0	0	0
Core enterprise value	18,997	26,612	27,824	21,529	22,632	22,770	22,969	24,223
Growth (%)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Revenue	7.7	8.0	5.4	-0.9	6.4	4.5	10.4	14.3
EBITDA (UBS)	-3.1	14.9	11.7	-24.0	-0.5	16.9	33.7	32.7
EBIT (UBS)	-11.9	21.0	10.1	-35.3	-4.2	23.1	47.2	42.1
EPS (UBS, diluted)	-25.0	56.8	0.3	-50.5	-4.2	27.3	75.9	50.9
Net DPS	26.9	-7.7	0.6	-46.8	-4.2	27.3	134.6	50.9
Margins & Profitability (%)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Gross profit margin	49.6	50.9	52.0	44.5	43.3	46.5	51.1	55.5
EBITDA margin	31.4	33.4	35.4	27.1	25.4	28.4	34.4	39.9
EBIT margin	23.7	26.5	27.7	18.1	16.3	19.2	25.6	31.8
Net earnings (UBS) margin	12.3	17.9	17.0	8.5	7.6	9.3	14.8	19.6
ROIC (EBIT)	12.6	14.1	14.1	8.4	7.5	8.6	12.0	16.3
ROIC post tax	9.0	10.6	10.2	6.0	5.3	6.2	8.8	11.6
ROE (UBS)	12.1	17.6	15.9	7.2	6.6	7.9	13.1	17.9
Capital structure & Coverage (x)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Net debt / EBITDA	2.1	2.1	2.0	3.0	3.3	3.0	2.3	1.6
Net debt / total equity %	63.5	65.5	62.8	66.1	70.7	71.6	66.4	55.4
Net debt / (net debt + total equity) %	38.8	39.6	38.6	39.8	41.4	41.7	39.9	35.6
Net debt/EV	35.2	27.7	29.2	41.7	44.4	47.3	47.0	41.4
Capex / depreciation %	NM	NM	NM	NM	NM	NM	NM	NM
Capex / revenue %	24.5	23.6	24.0	23.5	24.6	22.3	19.9	17.7
EBIT / net interest	3.7	9.6	6.5	2.9	2.9	3.1	4.9	7.4
Dividend cover (UBS)	2.1	3.6	3.6	3.3	3.3	3.3	2.5	2.5
Div. payout ratio (UBS) %	47.3	27.8	27.9	30.0	30.0	30.0	40.0	40.0
Revenues by division (R\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Others	9,942	10,738	11,316	11,219	11,943	12,478	13,776	15,741
Total	9,942	10,738	11,316	11,219	11,943	12,478	13,776	15,741
EBIT (UBS) by division (R\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Others	2,354	2,850	3,136	2,030	1,945	2,395	3,526	5,011
Total	2,354	2,850	3,136	2,030	1,945	2,395	3,526	5,011

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Forecast returns

Forecast price appreciation	-3.2%/-3.2%
Forecast dividend yield	2.6%/2.6%
Forecast stock return	-0.6%/-
Market return assumption	14.7%/10.1%
Forecast excess return	-15.3%/-

Statement of Risk

Key risks to our estimates or valuation: 1) higher than inflation tariffs to pay for high capex/poor hydrology (upside); 2) prolonged dry weather might mean rationalization of demand for longer, or rationing in the near term; 3) eventual corporate governance changes given its São Paulo state-owned condition; 4) no pass-thru of the costs with the Sao Paulo city contract; 5) lower opex and water losses.

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12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 December 2014.

1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS Brasil CCTVM S.A.: Lilyanna Yang, CFA; Carlos Herrera.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
SABESP ¹⁶	SBSP3.SA	Sell	N/A	R\$15.49	21 Jan 2015

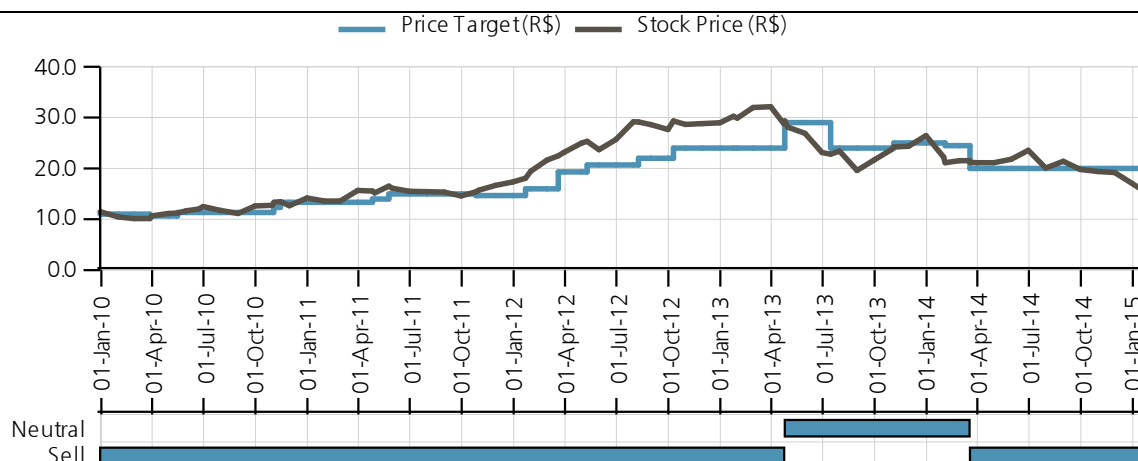
Source: UBS. All prices as of local market close.

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SABESP (R\$)



Source: UBS; as of 21 Jan 2015

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