MOODY'S

Rating_Action: Moody's downgrades AEGEA's ratings; changes outlook to stable

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New York, March 08, 2023 -- Moody's Investors Service ("Moody's") downgraded AEGEA Saneamento e Participacoes S.A's ("AEGEA") Corporate Family Rating (CFR) to Ba2 from Ba1 and Aegea Finance S.a r.l.'s ("Aegea Finance") senior unsecured rating to Ba3 from Ba2. The outlook on all ratings was changed to stable from negative. Governance considerations were relevant to this rating action, because Moody's views the company's accelerated growth strategy will have a prolonged impact to its capital structure and financial risk profile.

Downgrades:

..Issuer: AEGEA Saneamento e Participacoes S.A

....Corporate Family Rating: Downgraded To Ba2 From Ba1

..Issuer: Aegea Finance S.a r.l.

....Backed Senior Unsecured Notes: Downgraded To Ba3 From Ba2

Outlook Actions:

..Issuer: AEGEA Saneamento e Participacoes S.A

....Outlook, Changed To Stable From Negative

..Issuer: Aegea Finance S.a r.l.

....Outlook, Changed To Stable From Negative

RATINGS RATIONALE

The downgrade of AEGEA's Ba2 CFR follows the deterioration of its consolidated credit metrics through December 2022, along with Moody's perception that an improvement in the leverage profile will take longer to materialize. For fiscal year-end 2022, Moody's calculates the company's consolidated funds from operations (FFO)-to-net debt ratio have dropped to 10% in 2022, from an average of 14.3% in the previous three years (2019-2021). During the same period, the FFO interest coverage fell to 1.6x from 2.0x. Moody's revised baseline scenario for AEGEA considers an improvement in credit metrics following recent acquisitions, potentially converging to the historical average. But additional financing needs to support new investments amid higher borrowing costs will constrain a material improvement of AEGEA's credit profile over the three years.

Moody's also notes different financial arrangements being used for the execution of its expansion strategy, comprising indebtedness across the group's structure that generates encumbered cash at the subsidiaries levels and off-balance guarantees from the holding company. These structures add opacity and complexity to the cash flow analysis of the group, while also limiting the pace of leverage reduction. As a result, Moody's now assesses AEGEA's overall ESG Credit Impact Score as moderately negative (CIS-3), indicating ESG factors are considered as having a limited impact on the current rating, with greater potential for future negative impact over time.

The stable outlook reflects Moody's view that AEGEA's credit profile will remain well positioned in the Ba2 rating category over the next 12-18 months, supported by its solid market position, consolidated business profile with growing track record of successful investments.

AEGEA's Ba2 CFR remains supported by its consolidated business model, its geographically diversified operations regulated by long-term concession contracts that drives the stability and predictability of the company's revenues. The rating incorporates the planned acquisition of CORSAN, and continued improvement in operating performance of its existing businesses, including the ramp-up of Aguas do Rio. The execution risks of new investments are also factored in the rating with a view that consolidated free cash flow generation will remain negative over the next three-to-five years.

Moody's views an overall benign business environment for the water and sewage sector in Brazil that is not likely to suffer significant policy shifts following new elected federal and state governments. Although relatively new and still under development, the current regulatory framework for the sector allows for the participation of private companies into public auctions and partnerships with goverment owned companies, through long-term contracts with adequate cost recovery mechanisms, including the periodic rebalancing for changed economic conditions. Since the approval of the Sanitation Law in 2020, AEGEA took advantage of several investment opportunities to expand its business portfolio. At the same time, the company was granted tariff readjustment and rebalances, sustaining a solid cash generation.

AEGEA's liquidity profile is currently tight. As of fiscal year end, the company reported an unrestricted cash balance of BRL 1.8 billion that compares to BRL 2.2 billion in debt maturities through 2024. As such, the company depends on sound access to the banking and capital markets to address its refinancing needs. AEGEA's benefits from some financial flexibility provided by its diversified and a long debt maturity profile. The planned issue of debentures in the local capital markets for up to BRL600 million will partially address its short-term refinancing needs in 2023.

Aegea Finance's Senior Unsecured rating of Ba3 is positioned one notch below AEGEA's CFR to reflect the structural subordination since AEGEA does not hold any operations and is strictly a vehicle for controlling stakes on the operating subsidiaries. AEGEA largely depends on the regular payment of dividends that its operating subsidiaries upstream to allow the company to meet its debt obligations, equity investment commitments and potential cash requirements related to its guarantees. Aegea Finance's senior unsecured notes is fully guaranteed by AEGEA and ranks pari-passu to its outstanding and future unsecured debt.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Positive pressures on the company's ratings are unlikely over the next 12-18 months given the recent ratings downgrade, but could be exerted as new operations mature alleviating execution risks, combined with a simplification of the corporate structure and a visible deleveraging trend. Positive rating pressure would also build with evidence of strong shareholder support through planned equity injections or higher cash retention. Quantitatively, an upgrade would require FFO interest coverage stays above 2.5x and debt/capitalization stays below 70% on a sustained basis.

The ratings could be downgraded if there is further deterioration in the company's leverage metrics or liquidity. Quantitatively, downward pressure will increase if the FFO interest coverage stays below 1.8x or if the debt/capitalization approaches 80% on a sustained basis. The ratings could also come under pressure if there is deterioration in subsidiaries' performance, such that it reduces consolidated cash generation or leads to noncompliance with contractual targets. Moody's perception of reduced financial flexibility of the operating subsidiaries to support debt service at the holding company level could also imply further notching down of the Notes due to structural considerations.

COMPANY PROFILE

AEGEA is one of the largest private water and sewage players in Brazil, with 56% market share of the private sector. After consolidating Corsan and non-operating assets in the Ceará state, the company's services will reach 30 million individuals in 480 municipalities located in 13 states, through concessions with an average contracted life of 30 years. In 2022, AEGEA reported net revenue of BRL3.7 billion and EBITDA of BRL2.5 billion. FFO interest coverage was 1.6x in the year and Debt to Capitalization 62%, as per Moody's standard adjustments.

AEGEA's shareholders are Equipav (52.8% stake), the Government of Singapore Investment Corporation (34.3% stake) and Itausa S.A. (12.9% stake).

The principal methodology used in these ratings was Regulated Water Utilities published in June 2018 and available at https://ratings.moodys.com/api/rmc-documents/55428. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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