

Research Update:

Brazilian Utility SABESP Outlook Revised To Stable From Negative On Resilient Performance; 'BB-' Rating Affirmed

December 6, 2021

Rating Action Overview

- Despite the pandemic-induced shock, Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP) has been able to sustain its solid credit metrics, with debt to EBITDA of about 2.5x and adequate liquidity in recent quarters.
- Additionally, the state of São Paulo, SABESP's controlling shareholder, was hit less by the pandemic's effects than we anticipated and managed to improve its fiscal and liquidity positions in recent quarters while keeping prudent financial management policies.
- On Dec. 6, 2021, S&P Global Ratings revised its outlook on SABESP to stable from negative. We also affirmed our 'BB-' global scale and 'brAAA' national scale ratings on the Brazil-based water and sewage utility. The stand-alone credit profile (SACP) remains 'bb+'.
- The outlook revision reflects SABESP's performance in the last several quarters that confirmed our view of the company's solid governance standards, financial resilience, and a record of a hands-off approach by the state of São Paulo's government.

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Rating Action Rationale

SABESP's financial position has stayed solid. The outlook revision and ratings affirmation reflect our view that in recent quarters, SABESP has shown resilience to the pandemic-induced shock. The company ended this September with adjusted debt to EBITDA of 2.6x and funds from operations (FFO) to debt of 27.8%. SABESP was also able to reduce its exposure to foreign-currency fluctuations that stems from its debt denominated in U.S. dollars and Japanese yen, which now accounts for 18% of total debt compared with 21% as of Dec. 31, 2020, and about 50% at the end of 2019.

Since the beginning of the pandemic, the company had its tariffs readjusted two times (+3.4% in August 2020 and +7.0% in May 2021) by the state of Sao Paulo's regulatory agency--Agencia Reguladora de Serviços Públicos do Estado de Sao Paulo (ARSESP)--corroborating our view that

the regulatory framework in place is independent and has a record of good execution, ensuring that SABESP can continue investing to improve service coverage in the municipalities where it operates. Dividend payouts also continued at the modest levels seen in the last couple of years, which in our view, indicates that the government of the state of São Paulo (not rated), which is the company's controlling shareholder, hasn't interfered negatively in SABESP.

In addition, the state of São Paulo itself suffered less from the pandemic fallout than we originally anticipated. The state managed to improve its fiscal and liquidity position over the last quarters while maintaining prudent financial management policies. In our opinion, the combination of solid governance standards, financial resilience, and a track record of a hands-off approach by the government help mitigate potential negative government interference. In addition, while the dividends that we expect the company to distribute are not relevant when compared to the overall operating revenues of the state, SABESP is an important vehicle in terms of public investment in the local economy. We also believe that the incentives to impair the operations of an essential services provider are limited amid the ongoing public health crisis.

We continue to expect SABESP to be resilient to the state's hypothetical default. We view SABESP as a government-related entity (GRE) because the state of São Paulo owns 50.3% of the company. The remaining shares are publicly traded on the BOVESPA and the NYSE through American depository receipts.

In spite of the record of noninterference from the state of São Paulo, we continue to test SABESP's resilience to a hypothetical default of its controlling shareholder, which included an extraordinary increase in state tax, a delay in the application of tariffs, and much higher working capital needs from an increase in delinquency levels. In this hypothetical scenario, we expect SABESP to be relatively resilient to a state-level default.

Outlook

The stable outlook on SABESP for the next 12 months reflects our view that the company will maintain its solid credit metrics and liquidity, with debt to EBITDA around 2.5x and liquidity sources over uses above 1.1x, despite its sizable investment program of R\$17 billion until 2025. Also, as a regulated utility, the company is exposed to Brazil's overall economic conditions, so we cap our ratings on SABESP by those on the sovereign (BB-/Stable/B).

Downside scenario

Any negative rating action on the sovereign rating would trigger a downgrade of SABESP because we limit its credit quality by that of Brazil. We could also downgrade SABESP if FFO to debt falls below 9% or if debt to EBITDA surpasses 5.5x due to a combination of weaker operating performance--which could result from the impact of the COVID-19 pandemic lasting for much longer than expected or a drought--combined with a sharp depreciation of the Brazilian real. Finally, we could lower the ratings if we observe signs of negative interference from the state of São Paulo, for example if dividends payouts increase significantly above the ones seen in recent years.

Upside scenario

An upgrade in the next 12 months would rely on an upgrade of Brazil. We could revise the company's SACP upward if it consistently has debt to EBITDA below 2.0x and FFO to debt near

35%, mostly because of improving operating performance and lower debt.

Ratings Score Snapshot

Issuer credit rating:

Global scale: BB-/Stable/--

National Scale: brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

Likelihood of government support: Moderately high

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Full Analysis: SABESP, June 29, 2021

Ratings List

Ratings Affirmed

Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)		
Analytical Factors	bb+	
Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)		
Senior Unsecured	brAAA	
Ratings Affirmed; CreditWatch/Outlook Action		
	To	From
Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)		
Issuer Credit Rating	BB-/Stable/--	BB-/Negative/--
Brazil National Scale	brAAA/Stable/--	brAAA/Negative/--

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