FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms SABESP's IDRs at 'BB'; Outlook Stable

Tue 28 Apr, 2020 - 4:59 PM ET

Fitch Ratings - Sao Paulo - 28 Apr 2020: Fitch Ratings has affirmed Companhia de Saneamento Basico do Estado de Sao Paulo's (SABESP) Long-Term Foreign and Local Currency (LC) Issuer Default Ratings (IDRs) at 'BB' and its National Long-Term Rating at 'AA(bra)'. The Rating Outlook is Stable.

The rating action reflects Fitch's view that SABESP will be able to sustain its robust cash flow from operations (CFFO) and strong financial flexibility to manage its relevant debt maturities during the following quarters, even during the coronavirus pandemic. The company should keep its EBITDA margin in the 40%-45% range, which is above the average of its industry peers, and low to moderate leverage. SABESP's IDRs also incorporate its low business risk with near-monopolistic position as provider of an essential utility within its concession area, as well as the economies of scale obtained as the largest basic sanitation company in the Americas by number of customers.

Fitch views SABESP's expected negative FCF, due to its significant capex plans, and material FX debt exposure as limiting rating factors. The assessment also reflects SABESP's still-developing regulatory environment, the intrinsic hydrological risk of its business and the political risk associated with its position as a state-owned company subject to potential changes in management and strategy after each state of Sao Paulo government election.

Per Fitch's Government-Related Entity Criteria, Fitch assesses SABESP on a standalone basis. This approach is supported by the agency's perception of reduced incentive of SABESP's major shareholder to provide company support if needed, given minimum financial implications for the state of Sao Paulo if SABESP defaults, and limited evidence of a track record or expectations for the state providing support. SABESP's activities are independent from its major shareholder both financially and operationally. Fitch also considers the sociopolitical implications for the state in the case of the company's default as moderate, despite the strong assessment of its status, ownership and control by the state of Sao Paulo.

The Stable Outlook reflects Fitch's expectation that the water/wastewater industry will preserve solid fundamentals. SABESP should experience a limited change in volumes billed and a manageable higher delinquency ratio due to the coronavirus, sustaining its strong credit metrics.

KEY RATING DRIVERS

Reduced Business Risk: SABESP's credit profile benefits from resilient demand, even during a distressed economic environment, which should mitigate the negative impact of the coronavirus pandemic on its operations. The estimated moderately lower volume billed to commercial and industrial clients will be compensated by marginal growth from residential consumers, resulting on stable volume in 2020. Fitch assumed volume billed will grow 4.3% in 2021. The expected decrease on the average tariff, given lower tariffs for residential customers, should be partially balanced by annual tariff increases in line with inflation. SABESP's activity in the state of Sao Paulo, which has the country's largest GDP and population, is viewed as positive.

Capex Pressures FCF: Fitch considers SABESP's forecast pressured FCF for the coming years as negative to the rating. The base case scenario estimates an annual average negative FCF of BRL566 million for the next three years. The negative BRL700 million in 2020 incorporates BRL3.2 billion in capex and dividends distribution of BRL800 million. Positively, SABESP counts on sound estimated annual CFFO average of BRL3.9 billion during 2020-2022 to alleviate FCF pressure. Fitch estimates CFFO in 2020 at BRL3.3 billion, reflecting a lower average tariff and higher working capital given estimates of increased delinquency during the year.

Strong EBITDA Margins: SABESP's large scale of operations is one of the pillars for the company to achieve EBITDA margins above its state-owned peers in Brazil. Fitch believes EBITDA margin will remain strong despite expected moderate reduction to 41% in 2020 from 45% in 2019. Fitch estimates SABESP's 2020 EBITDA at BRL5.6 billion, with an increase to BRL6.5 billion in 2021 given expected rapid recovery to regular patterns after the end of restrictions on the population's mobility due the pandemic. Tariff increases of 2.5% in 2020 and 3.5% in 2021 should also moderate EBITDA effects.

Low Leverage: Fitch estimates SABESP's net leverage will remain below 2.5x over the next three years -- 2.3x in 2020, which is low for the industry and for its IDRs -- supported by strong EBITDA through the cycle and despite higher capex during this period. The net debt-to-EBITDA ratio was 1.8x at the end of 2019. Negatively, the company carries risks associated with its high percentage of foreign-currency debt, given its strategy of accessing international funding. The company may face cash flow effects due to strong FX depreciation during significant foreign currency debt maturing periods, which is the case in 2020.

Potential Regulatory Changes: Fitch incorporates no major impact on SABESP's operations and cash flow generation in the case of regulatory environment changes. Discussions about regulatory environment guidelines for national water/wastewater should facilitate greater participation of private players and enhance the investment capacity of the industry. Private players account for around 6% of the industry's market share. Fitch believes private growth should occur mainly at highly inefficient state-owned companies or local municipality operators, which is not the case for SABESP.

DERIVATION SUMMARY

SABESP's mature operations and its position as the largest water/wastewater utility in Brazil benefit its business profile in terms of economies of scale and capital structure when compared with Aegea Saneamento e Participacoes S.A. (LC and Foreign Currency [FC] IDRs BB/Stable), which has moderate leverage, reflecting its growth strategy. Aegea's credit profile nevertheless benefits from its diversified concessions within Brazil, while SABESP operates exclusively in the state of Sao Paulo, which concentrates operational and regulatory risks. SABESP also carries relevant FX debt exposure and political risk, given it is state owned. Both SABESP and Aegea have similar and strong EBITDA margins.

Compared with power-transmission companies Transmissora Alianca de Energia Eletrica S.A. (LC IDR BBB-/Stable and FC IDR BB/Stable) and Alupar Investimento S.A. (LC IDR BBB-/Stable and FC IDR BB/Stable), SABESP presents less predictable CFFO, higher regulatory risk and higher FX exposure. Those factors explain the difference on the LC IDRs, despite SABESP's expected lower leverage metrics

KEY ASSUMPTIONS

--Stable volume billed in 2020 and total annual average growth of 3.2% in the next three years, supported by expected population and connection growth, and stable consumption per connection;

--Annual tariff increases of 2.5% in July 2020, as approved by the regulator, and 3.5% in the following years, in accordance with Fitch's expected inflation rate and adjusted by a efficiency factor (called X factor) of 0.69%;

--Average annual capex of BRL3.8 billion in 2020-2022;

--Dividend of BRL800 million in 2020 and payout ratio of 27.9% of net profits thereafter.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Sustainable positive FCF generation;

--Lower FX debt exposure.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--EBITDA margins below 33%;

--Net leverage above 3.5x on a sustainable basis;

--Fitch's perception of higher political risk;

--Lower financial flexibility.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Financial Flexibility: SABESP's robust cash position and proven financial flexibility will be crucial for the company to manage its expected negative FCF and high level of debt maturity in 2020. The company's available free receivables (estimated at around BRL600 million monthly, or approximately 65% of total receivables) add to its capacity to raise funding.

SABESP's cash and equivalents of BRL2.3 billion at the end of 2019 covered only 0.8x its short-term debt of BRL2.9 billion, with this debt increasing to around BRL3.5 billion due to recent sharp FX devaluation. Its relevant short-term debt includes the USD350 million bonds that mature in December 2020. The company issued BRL1.5 billion in local on debenture in April 2020 and expects to disburse around BRL1.0 billion of funding during 2020, which was already approved to partially support its capex in the same period.

SABESP's total debt of BRL13.2 billion by the end of 2019 consisted mainly of multilateral agency loans (BRL5.8 billion), debenture issuances (BRL3.6 billion) and bonds (BRL1.4 billion). BRL6.4 billion, or 48% of its total debt, was linked with FX variation without any hedge protection. Only BRL2.6 billion of the company's total debt at the end of 2019 was secured by future flow of receivables linked with Banco Nacional de Desenvolvimento Economico e Social

(BNDES) and Caixa Economica Federal loans, which do not pressure unsecured rated issuances.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)	LT IDR	BB	Affirmed
	LC LT IDR	BB	Affirmed
	Natl LT	AA(bra)	Affirmed
• senior unsecured	LT	BB	Affirmed
• senior	Natl	AA(bra)	Affirmed

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Gustavo Mueller
Director

Primary Rating Analyst
+55 21 4503 2632

Mauro Storino
Senior Director
Secondary Rating Analyst
+55 21 4503 2625

Fernanda Rezende
Senior Director
Committee Chairperson
+55 21 4503 2619

MEDIA CONTACTS

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Corporate Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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