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Research Update:

Brazilian Utility SABESP 'BB' And 'brAAA' Ratings Affirmed On Privatization; Outlook Still Stable

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Rating Action Overview

- On July 22, 2024, Companhia de Saneamento Basico do Estado de Sao Paulo S.A. (SABESP) announced the conclusion of its secondary share offering, which lowered the state of Sao Paulo's ownership to about 18% from 50.3%, while Equatorial Energia S.A. made the sole offer to buy a 15% stake and became the reference investor.
- Although SABESP' new corporate governance limits the state's influence on the company's decisions, São Paulo remains a major shareholder.
- On July 26, 2024, S&P Global Ratings affirmed its 'BB' global scale and 'brAAA' national scale issuer credit and issue-level ratings on SABESP. We also kept our view that SABESP has a moderately high likelihood of receiving extraordinary government support.
- The outlook on SABESP remains stable, reflecting our expectation that it will maintain comfortable credit metrics in the next 12 months, with debt to EBITDA of 2.5x-3.0x and funds from operations (FFO) to debt of 20%-25%, while maintaining adequate liquidity. The company should benefit from efficiency gains and more transparent regulation, which should help to offset annual investments above R$10 billion over the coming years.

Rating Action Rationale

While the privatization reduced the state's stake, it still has influence on the company. Following the conclusion of the secondary share offering, in which the state of São Paulo sold 220.5 million of its shares of SABESP, its stake in the company dropped to 18% from 50.3%. According to the conditions of the privatization, Equatorial (brAAA/Stable/--) became the second-largest owner and reference investor after acquiring a 15% stake for R$6.9 billion, which must be maintained for minimum of a five-year period. Under the terms of the new corporate governance, Equatorial will appoint three out of nine board members, including the chairman and the CEO, while the state will appoint three, and the rest will be independent.

In addition, the offering provided the government a golden share that, among other conditions, prevents certain changes in the company's bylaws, and a poison pill mechanism that prevents a single investor (or a group of) to have a stake larger than 30%. As such, we still consider SABESP as a government-related entity (GRE), having a moderately high likelihood of receiving extraordinary support from the state. In addition, we consider that the company provides essential infrastructure services to the population, and its activities play an important public policy role. In addition, 30% of about R$15 billion received by the state from the company's privatization and 100% of the dividends that the state will receive will be deposited in a specific fund until 2029 that could be used to trim potential rate increases, given that SABESP is implementing massive investment, which is a sign of potential support, in our view.

More transparent regulations. The privatization also included the extension until 2060 of SABESP's concessions in 371 municipalities, as well improvements in regulations. Those include better defined operational and commercial parameters, which reduce the regulatory discretion and allow for higher revenues, including annual rate reviews starting in 2026. The latter will incorporate the company's large investments into regulatory asset bases and pass-through costs into rates until 2034.

In our view, SABESP should continue operating on a stand-alone basis, while benefiting from Equatorial's track record of turning around the operations of utilities, as was the case of its electricity distributor subsidiaries. In addition, we expect the company will eventually capture the benefits from more flexibility in procurement and personnel management, gradually improving its operating efficiency.

Despite massive investments, we expect SABESP to maintain comfortable credit metrics. SABESP has committed to achieve the universalization target of the 99% water and 90% sewage coverage across its concessions to 2029, which will require investments of approximately R$70 billion, prior to the 2033 target in the 2020 Sanitation Law. Still, we project it to maintain debt to EBITDA in the 2.5x-3.0x range and FFO to debt of 20%-25% in the next two years, as we expect the company to be able to fund its investments with a combination of internal cash generation and debt. We believe that SABESP will finance its projected free operating cash flow shortfall over the next several years with debt, based on its proven access to capital international and domestic capital markets, commercial and development banks, and multilateral lending agencies. Finally, the new dividend policy establishes that payouts increase following the completion of the investment program. This should also allow the company to maintain its adequate liquidity position.

Outlook

The stable outlook on SABESP for the next 12 months reflects our view that it will maintain comfortable credit metrics, with debt to EBITDA of 2.5x-3.0x and FFO to debt of 20%-25%, adequate liquidity, sources over uses above 1.2x, while it executes annual investments above R$10 billion over the coming years. Also, as a regulated utility, the company is exposed to Brazil's 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 would trigger a downgrade of SABESP because we limit its credit quality to that of Brazil. We could revise downward the company's stand-alone credit profile (SACP) in case of aggressive credit ratios, with FFO to debt consistently below 13% and debt to EBITDA above 3.5x.

Upside scenario

An upgrade of SABESP in the next 12 months would rely on an upgrade of Brazil. We could revise the company's SACP upward if it maintains debt to EBITDA below 2.5x and FFO to debt near 35%, mostly because of significant efficiency gains and low dividend distributions. The national scale rating is already at the highest level possible.

Company Description

Brazil-based SABESP is the largest water and sewage company in Latin America, based on the number of clients and net revenue. It supplies water to 28.1 million people and provides sewage collection services to 24.9 million people. The company operates water and sewage systems in 375 municipalities in the state of São Paulo, which generates about 31% of Brazil's GDP. Following the privatization, the state of São Paulo (not rated) now has a 18% stake of SABESP, followed by Equatorial (15%), and the remaining 67% portion now floating on the stock markets.

Our Base-Case Scenario

Assumptions

- In the next few years, hydrology conditions to be in line with the historical average.
- Demand for water and sewage services to increase 2%-3%, reflecting demographic conditions and economic growth.
- Following privatization, residential rates were reduced by 1%, social and vulnerable rates by 10%, and all other rates by 0.5%, applicable only to the first consumption tier. We assume rates to be adjusted to Brazil's inflation, which we project to be 4.2% in 2024, 3.8% in 2025, and 3.5% in the following years, according to our report, "Economic Outlook Emerging Markets Q3 2024: Growth On Track, Policy Risks Rising", published on June 24, 2024.
- Investments of R$8.1 billion in 2024, and above R$10 billion in 2025 and onward.
- Dividend payouts of 25% in 2024 and 2025, and 50% in 2026 in 2027.

Key metrics

- Annual FFO of about R$6.0 billion in 2024 and 2025;
- Debt to EBITDA of 2.5x-3x in the same period; and
- FFO to adjusted debt of 20%-25% in 2024 and 2025.

Our adjusted debt figures include pension-related liabilities of about R$2.1 billion.

Liquidity

We still view SABESP as having adequate liquidity, because we expect cash sources to uses to be above 1.2x in the next 12 months, and that the company will continue complying with its financial covenants. We also expect the difference between cash sources and uses to remain positive for the next 12 months even if forecasted EBITDA were to decline by 10%. We also believe that the company has flexibility to absorb high-impact, low-probability events with limited refinancing risk, as seen in its resilient performance during the 2015 drought. In our view, SABESP has wide access to credit and capital markets, and it has sound relationships with public and private banks, and multilateral lending agencies. SABESP's current cash on hand is more than sufficient to cover its debt maturities in the short term.

Primary Liquidity Sources:

- Consolidated cash and liquid investments of R$6.2 billion as of March 2024; and
- Projected cash FFO of about R$6.0 billion in the next 12 months.

Primary Liquidity Uses:

- Short-term debt maturities of R$2.7 billion as of March 31, 2024;
- Working capital outflows of about R$700 million in the next 12 months; and
- Minimum annual investments of about R$4.5 billion.

Covenants

SABESP is subject to several financial covenants on its debt contracts, with which it was in compliance as of March 2024. SABESP has also obtained all the necessary approvals and waivers on the change in control prior to its privatization. The company's debentures issuances (22nd, 23rd, 24th, 26th, 27th, 28th, 29th, 30th, and 31st) have the following financial covenants:

- Net debt to EBITDA of up to 3.5x; and
- EBITDA interest coverage of at least 1.5x.

These financial covenants are measured on a quarterly basis, and debt payment acceleration would occur only if the company is unable to comply with them for two consecutive or non-consecutive quarters in a 12-month period.

For the company's 18th debenture issuances and its loan from the Brazilian Development Bank (BNDES; except for the 08.2.0169.1 contract), compliance is measured on a quarterly basis through the following:

- Net debt to EBITDA of up to 3.8x;
- EBITDA interest coverage equal to or more than 2.8x; and
- Other debts to EBITDA equal to or less than 1.3x.

Covenants are considered breached if SABESP is unable to comply with these thresholds for two quarters in a 12-month period. For the BNDES loan, the company will be required to add additional receivables by 20% if covenants are breached.

For BNDES contract 08.2.0169.1, the following covenants are calculated on an annual basis:

- EBITDA margin of at least 38%;
- EBITDA interest coverage of 2.35x or higher; and
- Net debt to EBITDA of up to 3.2x.

We expect SABESP to comply with its financial covenants in the following few quarters, even if EBITDA declines by about 10%.

Government Influence

We continue to view SABESP as a GRE because the state of Sao Paulo still is the largest shareholder, owning 18.3% of the company. We continue to attribute a moderately high likelihood of support, which follows our view of the important role that the company plays due the essentiality of the services it company provides. Despite the privatization, we still view SABESP as having a strong link with the government, as the latter continues having significant influence on the company. And although the state no longer controls SABESP, it remains the largest shareholder, appointing three out of nine board members. Also, the state has a golden share that prevents changes in bylaws, and a poison pill mechanism that prevents investors from accumulating a stake in the company of 30% or more.

However, we believe that SABESP has solid governance standards, especially after the privatization, limiting the likelihood of the state intervening in the operations by redirecting financial resources, which could weaken the GRE, especially amid the government's fiscal strains. In addition, the state of Sao Paulo has a record of a hands-off approach toward GREs, all of which help mitigate the risk of potential interference.

Finally, while dividends that the company expects to distribute account for a small share of the state's overall operating revenue and SABESP still plays an important role in the local economy, we tested its resilience to a hypothetical default of the state. The stress test included an extraordinary increase in state tax, a delay in adjusting rates, and much higher working capital needs because of the rise in delinquency levels. We expect SABESP to be relatively resilient to such a hypothetical scenario.

Ratings Above The Sovereign

As a regulated utility, the company is sensitive to Brazil's overall economic conditions, so we cap our ratings on SABESP to those on the sovereign.

Issue Ratings - Subordination Risk Analysis

Capital structure

We rate SABESP's following debt instruments at 'brAAA':

- R$865 million 23rd debentures due in 2027;
- R$523 million 24th debentures that mature in 2029;
- R$1.331 billion 26th debentures due in 2030;
- R$1.698 billion 27th debentures that mature in 2027; and
- R$1.198 billion 28th debentures due in 2028.

SABESP's capital structure consists of about R$22.0 billion in debt, including its senior unsecured debt.

Analytical conclusions

All the issue-level ratings on SABESP are at the same level as our global and national scale issuer credit ratings on the company. This is because SABESP issued all the rated debt at the operating level, and less than 20% of its debt is secured, and consequently, doesn't pose a significant disadvantage to the unsecured creditors.

Ratings Score Snapshot

Foreign currency issuer credit rating	BB/Stable/--
Local currency issuer credit rating	BB/Stable/--
Business risk	Satisfactory
Country risk	Moderately high
Industry risk	Very low
Competitive position	Satisfactory
Financial risk	Significant
Cash flow/leverage	Significant
Anchor	bb+
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bb+

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
Companhia de Saneamento Basico do Estado de Sao Paulo	
Issuer Credit Rating	BB/Stable/--
Brazil National Scale	brAAA/Stable/--
Companhia de Saneamento Basico do Estado de Sao Paulo	
Senior Unsecured	brAAA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.