Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP) (/gws/en/esp/issr/80614473)

FitchRatings

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

Fitch Ratings-Sao Paulo-04 May 2018: Fitch Ratings has affirmed Companhia de Saneamento Basico do Estado de Sao Paulo's (Sabesp) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB' and its National Long-term rating at 'AA(bra)'. The Rating Outlook is Stable. A full list of rating actions follows at the end of this release.

Sabesp's IDRs reflect its low business risk associated with its near monopolistic position as a provider of an essential service to the population within its concession area, as well as on the economies of scale obtained as the largest basic sanitation company in the Americas by number of customers. These characteristics combined with its matured operations allow Sabesp to present predictable operational cash flow generation and strong EBITDA margins. The company's credit profile also benefits from its conservative capital structure, robust liquidity position and manageable debt maturity profile. Fitch believes the company will operate under adequate tariff adjustments combined with gradual recovery in water and sewage volumes billed in the coming years.

Fitch sees Sabesp's expected negative free cash flow (FCF) due to its significant capex plans and the relevant FX debt exposure as limiting rating factors. The assessment also reflects the still developing regulatory environment for Sabesp, the intrinsic hydrological risk of its business and the political risk associated with its condition of state-owned company subject to the potential changes in management and strategy after each election for the Government of the State of Sao Paulo.

KEY RATING DRIVERS

Reduced Business and Industry Risks: Fitch estimates total volume billed growth of around 2% for the next three years and after strong volume recovery during 2016-2017 following the reduction during the hydrological crisis. Sabesp benefits from resilient demand as demonstrated during 2013-2015 distressed operating environment when the company's volume billed dropped only by 8.5%, which enhances the predictability of its operating cash flow generation. Its activity in the State of Sao Paulo, which presents the highest GDP in the country, is also viewed as positive. The company has been able to implement adequate tariff adjustments, maintaining the economic and financial balance of its concession agreement, despite the developing regulatory environment.

Strong EBITDA Margin: Sabesp's high operational scale is one of the pillars for the company to achieve EBITDA margins above its state owned peers in Brazil. Fitch believes EBITDA margin will be around 45% in the coming years, which compares with 41% on average in the last five years influenced by the distressed operating scenario. In 2017, EBITDA of BRL5.3 billion represented a margin of 46%. Based on it, Fitch estimates Sabesp will sustain its strong cash flow from operations (CFFO) generation, reaching BRL3.8 billion in 2018, supported by growth in volumes billed and adequate tariff adjustments. Sabesp's CFFO was strong at BRL3.3 billion in 2017, benefiting from a 4.3% increase in volumes and a 6.0% average tariff increase when compared to the previous year, despite relevant working capital requirement.

Manageable Negative FCF: Fitch estimates Sabesp's negative FCF of BRL111 million on average for the next three years, being approximately at break even in 2018. The company's FCF performance is to reflect the expected capex increase to BRL2.9-3.5 billion in 2018-2020. Positively, Sabesp counts on favourable financial flexibility from debt issuances with multilateral agencies with reduced cost and lengthened amortization schedule in addition to proven access on local and international debt markets to comfortably fund this negative FCF. Fitch projects Sabesp's annual dividends distribution manageable of around BRL722 million on average during 2018-2020. In 2017, FCF was positive at BRL559 million, after capex of BRL2 billion and dividends of BRL760 million.

Conservative Capital Structure: Fitch estimates Sabesp's net leverage below 2.0x in the next three years, which is low for the industry and for its IDR. Sabesp's conservative credit metrics should be supported by the expectation of sound EBITDA generation at BRL5.7 billion by the end of 2018 up to BRL6.3 billion by 2020, and despite expected capex increase. In 2017, total debt/EBITDA and net debt/EBITDA of 2.3x and 1.9x, respectively, showed consistent development from 4.0x and 2.8x, respectively, in 2015.

High FX Debt Exposure: Sabesp should remain carrying risks associated with its high percentage of foreign-currency debt (47% of total debt by the end of December 2017) given its strategy to accessing international funding. Risks are mainly linked with cash flow impact in the case of strong devaluation during significant foreign currency debt maturing periods and financial covenants calculations, as the company is subject to the 3.65x gross leverage covenant. Nevertheless, Fitch estimates that Sabesp currently carries enough financial headroom to moderate the impacts of an eventual relevant FX devaluation.

Manageable Hydrological Risk: Sabesp's reservoirs are at manageable levels to face the dry rainfall season during 2018. The company's implemented actions to enhance water systems interconnection and higher supply capacity has improved its operating flexibility, which further mitigates hydrology concerns and should provide stronger resilience to the company's CFFO generation capacity to face unfavourable operating scenario.

DERIVATION SUMMARY

Sabesp's matured operations and its condition as the largest water/wastewater utility in the country, benefits its business profile in terms of economy of scale and capital structure when compared with Aegea Saneamento e Participacoes S.A.'s (Aegea - Long-Term Foreign and Local Currency IDRs BB/Stable), that presents moderate leverage reflecting its growth strategy. On the other hand, Aegea's credit profile benefits from its diversified concessions within Brazil, while Sabesp operates exclusively in the State of Sao Paulo, which brings higher operational and regulatory risks. Sabesp also carries a political risk given its state-owned condition. Both Sabesp and Aegea have similar and strong EBITDA margins.

In comparison with Transmissora Alianca de Energia Eletrica S.A. (Taesa - Long-Term Foreign Currency IDR BB/Stable and Local Currency IDR BBB-/Stable), the transmission company presents a better credit profile than Sabesp due to its even more predictable CFFO, strong financial profile and lower regulatory risk). In addition, Taesa does not carry hydrological, political and FX risks.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
--Total annual average volume billed growth of around 2% during the next three years supported by expected population and connections growth;
--Annual tariff increase of 4.8% in 2018 and 4.3% thereafter and according with Fitch's expected inflation. Tariff increases have been adjusted with the X Factor of 0.94%;
--Average annual capex of BRL3.4 billion from 2018 to 2021;
--Dividends payout ratio of 30.5% of net profit (net of legal reserves).

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
--Sustainable positive FCF generation;
--Lower FX debt exposure.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
--EBITDA margins below 33%;
--Net leverage above 3.5x on a sustainable basis;
--Fitch's perception of higher political risk.

LIQUIDITY

Robust Liquidity Profile: Fitch's expectation is that Sabesp will continue to benefit from its proven financial flexibility, maintenance of adequate liquidity position and lengthened debt maturity schedule. The company's financial flexibility is enhanced with its available free receivables (estimated at around BRL600 million monthly-approximately 65% of total receivables) to be offered as collateral for debt issuances, if necessary, in addition to access to various sources of funding including multilateral agencies loans specific for the water/wastewater segment. At the end of December 2017, cash balance of BRL2.3 billion comfortably covered short-term debt of BRL1.7 billion by 1.3x.

In the same period, Sabesp's total debt of BRL12.1 billion consisted mainly of multilateral agency loans (BRL4.0 billion), debenture issuances (BRL3.5 billion) and bonds (BRL1.2 billion). From its total debt, BRL5.7 billion (or 47%) was linked with FX variation without any hedge protection. There is BRL1.1 billion maturing until 2019 exposed to FX variation, and BRL1.4 billion maturing in 2020, mainly composed of the USD350 million bonds. At the same time, BRL3.7 billion of the company's total debt was secured by future flow of receivables linked with Baco Nacional de Desenvolvimento Economico e Social (BNDES) and Caixa Economica Federal (Caixa) loans.

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:

Sabesp

--Long-Term Local Currency IDR at 'BB';
--Long-Term Foreign Currency IDR at 'BB';
--USD350 million notes at 'BB';
--National Long-Term rating at 'AA(bra)';
--21st senior unsecured debentures at 'AA(bra)';
--22nd senior unsecured debentures at 'AA(bra)'.

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Summary of Financial Statement Adjustments - Financial statement adjustments that depart materially from those contained in the published financial statements of the relevant rated entity or obligor are disclosed below: Construction revenues are excluded from net revenues.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018)
(https://www.fitchratings.com/site/re/10023785)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018)
(https://www.fitchratings.com/site/re/10019302)
National Scale Ratings Criteria (pub. 07 Mar 2017)
(https://www.fitchratings.com/site/re/895106)

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