FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Sabesp's Ratings; Outlook Stable

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Fitch Ratings - Rio de Janeiro - 12 Apr 2024: Fitch Ratings has affirmed Companhia de Saneamento Basico do Estado de São Paulo's (Sabesp) Foreign Currency (FC) and Local Currency (LC) Issuer Default Ratings (IDRs) at 'BB+'. Fitch has also affirmed Sabesp's National Scale Rating and its unsecured debenture issuances at 'AAA(bra)'. The Rating Outlook is Stable.

Sabesp's ratings reflect its solid business and financial profile within the water/wastewater industry in Brazil, with benefits coming from its large scale in the industry. Fitch expects the company to maintain conservative net leverage and robust liquidity, despite forecasted negative FCFs due to an even more aggressive capex plan than previously anticipated.

The analysis incorporates Fitch's view of the company's ownership exposure to its majority shareholder, the state of Sao Paulo (IDR, BB/Stable), and the allowance of the LC IDR up to two notches above of the parent's rating, as per Fitch's criteria, which is currently is not a constrain.

KEY RATING DRIVERS

Porous Linkage Assessment: Sabesp's assessment of its Standalone Credit Profile (SCP) is commensurate with a LC IDR of 'BB+'. Nevertheless, as a company controlled by the state of Sao Paulo, Fitch applied the Government-Related Entities and Parent and Subsidiary Linkage Rating Criteria, which resulted in the issuer's LC IDR allowance at two notches above its parent's IDR.

Considering that the state of Sao Paulo's IDR is 'BB', Sabesp's LC IDR can reflect its SCP. Fitch considers strong the decision-making influence of the state of São Paulo over Sabesp's operations and its oversight robust. In addition, there is porous legal ring-fencing and porous access and control between the company and its main shareholder.

Low Business Risk: Sabesp's credit profile benefits from its almost monopolistic position for provision of an essential service in its concession area. It presents economies of scale as the largest water/wastewater company in the Americas by number of customers, which adds to its profitability.

The analysis considers the evolving regulatory environment, the hydrological risk intrinsic to its business and the political exposure as a state-owned company, with potential shift in strategies after each election for the government of Sao Paulo. The company's activity in the state of Sao Paulo is favorable, given the state's largest GDP and population in the country.

High Revenue Predictability: Sabesp's credit profile benefits from resilient demand and track record of adequate tariff increases that supports its high revenue predictability. Fitch assumed tariff increase already approved of 6.45% to be implemented in May 2024 and in line with inflation estimates of around 3.5% thereafter.

The company also benefits from required revenue framework in which it must receive or return revenue to customers in the following year, by means of a tariff adjustment, if realized revenues fall outside the range +/-2.5% from the regulatory required revenue. This revenue protection mechanism should be reviewed by Sabesp's regulatory entity in the next tariff revision estimated to occur in 2025 and Fitch does not anticipate any relevant changes on the company's revenue low volatility.

EBITDA Margin Above Peers: Fitch expects Sabesp to keep its EBITDA margin in the 45%-50% range, which is high and compares favorably with its state-owned peers in Brazil. In the base case scenario for the rating, the company's EBITDA margin reaches 45% in 2024 and increases to 47% in 2025 mainly supported by operating efficiency gains. Total volume billed should grow by 1.4% on average annually during this period, given the increasing number of connections. Projection assumes manageable levels of water losses and delinquency and no water supply restrictions as reservoirs are currently at comfortable levels.

Heavy Investment Cycle: Sabesp significantly increased its capex plan for the 2024-2027 period to BRL39 billion from BRL24 billion previously expected, which should further pressure its FCF. Fitch projects the issuer's EBITDA of BRL10.3 billion and cash flow from operations (CFFO) of BRL4.9 billion in 2024, resulting in negative FCF of BRL4.2 billion after relevant investments of BRL8.1 billion and dividends of BRL1.0 billion. Annual FCF in 2025-2026 should average negative BRL5.7 billion, after robust average CFFO of BRL6.2 billion, investments of BRL11.0 billion and expected dividends of around BRL950 million on average per year. Working capital pressure should ease as the company improves commercial measures.

Low to Moderate Leverage: The leverage metrics of Sabesp should remain low to moderate over the rating horizon, despite of heavy negative FCFs. The base case scenario considers the total debt-to-EBITDA and net debt-to-EBITDA ratios to increase but remain below 3.5x and 3.0x, respectively, which are conservative for the industry. Fitch forecasts gross leverage of 2.2x and net leverage of 2.0x in 2024 and peaking by 2027 as the company implements its capex plan.

Possible Privatization Should Be Neutral: The ongoing strategy for possible change in Sabesp's ownership structure should not impact the ratings. Potential impact on the company's ratings deriving from privatization will depend on the updates mainly in capex, dividend and financial policies materially different from current assumptions. The assessment after conclusion of eventual privatization will also consider expectations on efficiency gains and profitability improvements.

DERIVATION SUMMARY

Sabesp's mature operations and its position as the largest water/wastewater utility in the Americas benefit its business profile, in terms of economies of scale and financial structure, when compared with Aegea Saneamento e Participacoes S.A. (Aegea; LC and FC IDRs BB/Stable), which has moderate leverage, reflecting its growth strategy, partially mitigated by stronger EBITDA margins.

Sabesp's sound CFFO generation capacity also supports the one notch difference on the IDR, despite exposure to political risk. Aegea's credit profile benefits from its diversified concessions within Brazil, while Sabesp operates exclusively in the state of Sao Paulo, which concentrates operational and regulatory risks.

Compared with power-transmission company Alupar Investimento S.A. (LC IDR BBB-/Stable; FC IDR BB+/Stable), Sabesp presents higher regulatory risk, lower operational cash flow predictability and less asset diversification, which explain the difference on the LC IDRs, despite Sabesp's expected lower leverage metrics.

Sabesp favorably compares with Namibia Water Corporation (NamWater; FC and LC IDRs BB-/Stable), a government-related entity in Namibia that has its ratings constrained by the shareholder given Fitch's view of legal ring-fencing and access and control as 'open', which leads to the company's IDRs being constrained by the sovereign's. NamWater SCP is 'bbb-' supported by the company's role as the water supplier in Namibia, with a cost pass-through tariff framework and a strong financial profile.

KEY ASSUMPTIONS

--Total volume billed growth of 1.6% in 2024 and on annual average for 2025-2026, supported by growth of connections and overall stable volume/connection consumption;

--Total annual tariff increase of 6.45% in May 2024 and 3.5% thereafter - in line with Fitch's inflation estimates;

--Average annual capex of BRL10.0 billion in 2024-2026;

--Average annual dividends of BRL953 million in 2024-2026, equivalent to a payout ratio of 29% of net profits.

RATING SENSITIVITIES

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

--A positive rating action on the LC IDR depends on FCF at least neutral to slightly negative;

--A positive rating action on the FC IDR depends on the same movement on the LC IDR and on the Brazilian Country Ceiling;

--An upgrade of the National Scale Ratings is not possible as the rating is at the top of the national scale.

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

--Negative action on the Brazilian Country Ceiling will lead to negative action on the FC IDR;

--Negative rating action on the state of São Paulo rating by more than one level may lead to negative action on the FC and LC IDRs;

--EBITDA margins below 40%;

--Net leverage sustained above 3.0x;

--Increased political and/or regulatory risk;

--Lower financial flexibility.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity Profile: Sabesp's robust cash position and strong access to the financial market are key factors for the rating, as they enable the company to manage its forecasted negative FCF and refinancing needs. Sabesp's cash position of BRL3.3 billion at end of 2023 was sound and covered its short-term debt of BRL2.5 billion by 1.3x.

Total debt of BRL19.4 billion had an extended maturity profile and consisted primarily of funding from multilateral agencies of BRL8.4 billion, BRL7.4 billion in debenture issuances, and BRL3.0 billion from Caixa Economica Federal (Caixa) and Banco Nacional de Desenvolvimento Economico e Social (BNDES).

Foreign currency debt corresponding to 14% of total debt represents reduced exposure risk to currency volatility. At the end of 2023, only Caixa's and BNDES's debt was secured by receivables that represents less than 0.3x its EBITDA and does not pressure the ratings of unsecured issuances.

ISSUER PROFILE

Sabesp is the basic sanitation concessionaire that provides treated water supply and sewage collection and treatment services in 376 of the 645 municipalities in the state of São Paulo (Brazil). The company directly supplies water to 28 million people and provides sewage collection services to 25 million. Sabesp is controlled by the state of São Paulo and listed on B3 S.A. - Bolsa Brasil, Balcão (Novo Mercado) and the New York Stock Exchange (ADR Level III).

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 is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)	LT IDR	BB+ Rating Outlook Stable	Affirmed	BB+ Rating Outlook Stable
	LC LT IDR	BB+ Rating Outlook Stable	Affirmed	BB+ Rating Outlook Stable
	Natl LT	AAA(bra) Rating Outlook Stable	Affirmed	AAA(bra) Rating Outlook Stable
senior unsecured	Natl LT	AAA(bra)	Affirmed	AAA(bra)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub. 12 Jan 2024)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)	EU Endorsed, UK Endorsed

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