



RATING ACTION COMMENTARY

Fitch Affirms Sabesp's Ratings

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Fitch Ratings - Rio de Janeiro - 06 May 2022: Fitch Ratings has affirmed Companhia de Saneamento Basico do Estado de São Paulo's (Sabesp) Local Currency (LC) Issuer Default Rating (IDR) at 'BB+', Foreign Currency (FC) IDR at 'BB' and National Scale Rating at 'AAA(bra)'. At the same time, Fitch revised the LC IDR Outlook to Negative from Stable. The Rating Outlook remains Negative on the FC IDR and Stable on the National Scale Rating.

The LC IDR Outlook revision to Negative reflects Fitch's latest view on Sabesp's ownership exposure derived from porous legal ring-fencing and porous access and control from its majority shareholder - State of São Paulo (BB-/Negative). This approach results in the rating being constrained up to two notches from parent's rating, as per Fitch's criteria. The ratings also consider the solid fundamentals of the water/wastewater industry in Brazil and Sabesp's solid business profile. The company is expected to maintain conservative net leverage and a robust liquidity position, despite forecast negative FCF. The Negative Outlook on the FC IDR follows Brazil's sovereign Outlook.

KEY RATING DRIVERS

Porous Linkage Assessment: Sabesp's assessment considers that its standalone credit profile is commensurate with a LC IDR of 'BB+'. Nevertheless, as a company controlled by the State of São Paulo, Fitch applied the Government-Related Entities and Parent and Subsidiary Linkage Rating Criteria, which resulted in the issuer's LC IDR limited at two notches above its parent's IDR. Considering that the State of São Paulo' IDR is 'BB-', Sabesp's LC IDR can reflect is SCP of 'BB+', but the Outlook of both IDRs must be equalized as Negative. Fitch considered the strength of linkage between them as moderate and the incentive to support as weak to moderate. In addition, the company presents porous legal ringfencing and porous access and control.

Low Business Risk: Sabesp's credit profile benefits from its almost monopolistic position for provision of an essential service in its concession area. The issuer presents economies of scale as the largest water/wastewater company in the Americas by number of customers, which adds to 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 changes in strategies after each election for the government of São Paulo. The company's activity in the state of São Paulo is favorable given the state's largest Gross Domestic Product (GDP) and population in the country.

High Revenue Predictability: The approved required revenue until 2024 improves Sabesp's cash flow predictability. The company implemented a tariff increase of 12.8% in May 2022 that includes 2.4% of regulatory adjustment to compensate for lower verified revenue compared with minimal required revenue during the previous 12 months. Sabesp had approved for regulatory year May 2021-April 2022 the required revenue of BRL17.5 billion and for May 2022-April 2023, BRL18 billion. The company must receive or return revenue to customers in the following year, by means of a tariff adjustment, if actual revenues fall outside the range +/-2.5% from the required revenue.

EBITDA Margin Above Peers: Fitch expects Sabesp to keep its EBITDA margin on the 40%-45% range, which is high and compares favorably with its state-owned peers. On the base case scenario for the rating, the company's EBITDA will reach BRL7.2 billion in 2022 (42% margin), with a gradual growth to BRL8.0 billion by 2024 (43%). Total volume billed should increase by 1,5% on annual average given higher number of connections. The rating base case scenario assumes manageable levels of water losses and delinquency.

Heavy Investment Cycle: Sabesp's large capex program should pressure its FCF in the coming years. Fitch projects Sabesp's cash flow from operations (CFFO) at BRL3.4 billion in 2022, resulting in a negative FCF of BRL2.0 billion after investments of BRL4.8 billion and dividends of BRL644 million. 2023-2025 annual FCF is expected to average BRL1.2 billion negative, after robust CFFO of BRL4.6 billion, investments of BRL5.2 billion and expected dividends of BRL609 million on average per year. Working capital pressure should ease as the company had concluded implementation of new commercial management system.

Low Leverage: Sabesp's leverage metrics should remain low over the rating horizon, despite of relevant planned investments to expand service capacity and coverage. The base case scenario considers that the total debt-to-EBITDA and net debt-to-EBITDA ratios will remain below 3.0x and 2.5x, respectively, which are conservative for the industry. Fitch forecasts gross leverage of 2.6x and net leverage of 2.3x from 2022 to

2024, compared with an annual average of 2.6x and 2.1x, respectively, from 2019 to 2021.

New Regulatory Environment: Sabesp's ratings do not incorporate a major impact of recent regulatory changes in its operations and cash flow. Discussions regarding the national regulatory guidelines for the sanitation service should facilitate greater participation by private companies and increase the investment capacity of the sector. The increase in the participation of the private sector should occur mainly at the expense of more inefficient state-owned companies or municipal operators, which is not the case of 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 financial structure when compared with Aegea Saneamento e Participacoes S.A. (Aegea; LC IDR BB/Stable and FC IDR BB/Negative), which has moderate leverage, reflecting its growth strategy, partially mitigated by strong EBITDA margins. SABESP's strengthened CFFO generation capacity after the third tariff revision in 2021 also supports the one notch difference on the LC 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 companies Transmissora Alianca de Energia Eletrica S.A. (LC IDR BBB-/Negative and FC IDR BB/Negative) and Alupar Investimento S.A. (LC IDR BBB-/Negative and FC IDR BB/Negative), 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.

KEY ASSUMPTIONS

--Total volume billed growth of 1.5% in 2022 supported by growth of connections and marginal decrease on volume/connection for residential segment;

--Total annual tariff increase of 12.8% in May 2022 and in line with inflation estimates for the next years, resulting on revenues within regulatory required revenue range;

--Average annual capex of BRL4.9 billion in 2022-2024;

--Dividends of BRL644 million in 2022 and a payout ratio of 30% of net profits thereafter.

RATING SENSITIVITIES

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

--The Outlook revision to Stable on the LC IDR depends on the same movement on the rating of the state of Sao Paulo;

--The Outlook revision to Stable on the FC IDR depends on the same movement on the sovereign rating;

--Upgrade on National Scale Ratings does not apply as the rating is at the top of the national scale.

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

--Negative rating actions on the sovereign rating may lead to negative action on FC IDR;

--Negative rating actions on the state of São Paulo rating may lead to negative action on the LC IDR;

--EBITDA margins below 40%;

--Net leverage sustained above 3.0x;

--Increased political and/or regulatory 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 Liquidity Profile: Sabesp's robust cash position and strong access to the financial market are a key factor for the rating as they enable the company to manage its forecast negative FCF and refinancing needs. Sabesp's cash position of BRL3.2 billion at the end of 2021 covered its short-term debt of BRL1.8 billion by 1.8x. Total debt of BRL17.6 billion had an extended maturity profile and consisted mainly of funding from multilateral agencies of BRL6.7 billion, BRL7.3 billion in debenture issuances and BRL2.9 billion from Caixa and BNDES. Foreign currency debt corresponding to 19% of total debt represents moderate exposure risk to currency volatility. At the end of the 2021, only debt of Caixa and BNDES was secured by receivables that represents less than 0.5x its EBITDA and does not pressure the ratings of unsecured issuances.

ISSUER PROFILE

Mainly controlled by the State of São Paulo, Sabesp is a basic sanitation concessionaire that provides treated water supply and sewage collection and treatment services in 375 of the 645 municipalities in São Paulo. São Paulo is the most populous state in Brazil and accounts for the largest share of the national GDP. The company directly supplies water to 27.8 million people and sewage collection services to 24.6 million. The company is listed on B3 S.A. - Bolsa Brasil, Balcão (Novo Mercado) and the New York Stock Exchange (ADR Level III).

SUMMARY OF FINANCIAL ADJUSTMENTS

--Construction revenue is excluded from total revenues;

--Operating leases are not considered as debt;

--In the cash flow statement, the amount of related to "public-private partnership" is transferred to operating cash flow from financing cash flow.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

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

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APPLICABLE CRITERIA

[Government-Related Entities Rating Criteria \(pub. 30 Sep 2020\)](#)

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Corporate Rating Criteria \(pub. 15 Oct 2021\) \(including rating assumption sensitivity\)](#)

[Parent and Subsidiary Linkage Rating Criteria \(pub. 01 Dec 2021\)](#)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.2 (1)

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