

Research Update:

Companhia de Saneamento Basico do Estado de Sao Paulo Outlook Revised To Negative; 'BB-' Ratings Affirmed

June 12, 2020

Rating Action Overview

- The social distancing measures to contain the COVID-19 pandemic and the resulting economic fallout are putting significant fiscal pressure on the state of Sao Paulo. However, at this point we don't forecast the state to have incentive to take actions that could impair SABESP's credit profile.
- On June 12, 2020, S&P Global Ratings affirmed its 'BB-' global scale and 'brAAA' national scale issuer and issue-level credit ratings on Brazil-based water and sewage company Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP). The stand-alone credit profile (SACP) remains 'bb+'.
- We revised the outlook to negative from stable, reflecting our view that the company could be ultimately subject to negative intervention from the government, because it's subject to state-level regulation.

PRIMARY CREDIT ANALYST

Marcelo Schwarz, CFA
Sao Paulo
(55) 11-3039-9782
marcelo.schwarz
@spglobal.com

SECONDARY CONTACT

Vinicius Ferreira
Sao Paulo
+ 55 11 3039 9763
vinicius.ferreira
@spglobal.com

Rating Action Rationale

Outlook reflects possibility of government interference. The ratings affirmation and outlook change reflects our view that while SABESP is exposed to the overall fiscal weakness of the state of São Paulo (not rated), at this point we don't expect extraordinary action from the state government that could erode the group's liquidity and credit metrics. In our view, this situation could change if the economic and fiscal crisis worsens, because the impact of the COVID-19 pandemic and subsequent economic downturn have already significantly hit Brazilian local and regional governments' (LRGs) overall tax collection, while increasing expenditure pressures.

Therefore, the negative outlook reflects the fact that because SABESP is regulated by the state of Sao Paulo's regulatory agency--Agencia Reguladora de Saneamento e Energia do Estado de Sao Paulo (ARSEP)--the regulatory agency could ultimately be a source of interference, because it's responsible for authorizing SABESP's annual rate adjustments. Nevertheless, we acknowledge

that the regulatory framework in place has a track record of good execution, and has ensured that SABESP can continue investing to improve service coverage in the municipalities where it operates.

Although it's a GRE, we expect SABESP to be relatively resilient to the state's hypothetical default. In general, the credit quality of the Brazilian LRGs usually limits those of the entities they control. We attribute varying degrees of likelihood of support from the states to these companies. However, we also believe states might intervene by redirecting resources to the government and could therefore weaken government-related entities (GREs), especially amid challenging fiscal conditions.

We view SABESP as a GRE because the state of São Paulo owns 50.3% of the company. The remaining shares are publicly traded on the B3 S.A. – Brasil, Bolsa, Balcão (Brazil's stock exchange) and the NYSE through American depository receipts. We believe that SABESP has solid governance standards, a record of a hands-off approach by the government, and financial resilience, which helps mitigate the risk of potential interference. In addition, while the dividends that the company is expected to distribute aren't relevant when compared to the overall operating revenues of the state, SABESP is an important vehicle for the state in terms of public investment in the local economy. We also believe that the state's incentive to impair an essential services provider is limited amid this unprecedented public health crisis.

Finally, we tested SABESP's resilience to a hypothetical default of the state of São Paulo. Due to the overall weak Brazilian economy and the fact that our base case already reflects stressed conditions, the level of stress incorporated into our test on SABESP was limited and included an extraordinary increase in state tax, a delay in the application of tariffs, and much higher working capital needs because of an increase in delinquency levels. In this hypothetical scenario, we expect SABESP to be relatively resilient to a state-level default.

Outlook

The negative outlook on SABESP for the next 12 months reflects our view that as a regulated utility, the company could be ultimately subject to intervention in an unlikely and hypothetical government default scenario

Downside scenario

We could lower the ratings in the next 12 months if the COVID-19 pandemic lasts longer than expected and the economic and fiscal crisis heightens, further hitting SABESP's controlling shareholder, the state of São Paulo. This could translate into potential interference in either the company's financial policy or in its tariff adjustments.

Any downgrade on the sovereign would also trigger a downgrade of SABESP because we limit its credit quality by that of Brazil (foreign currency: BB-/Stable/B).

We could also downgrade SABESP based on its own fundamentals if funds from operations (FFO) to debt falls below 9% or if debt to EBITDA surpasses 5.5x. This could occur due to a combination of weaker operating performance--which could result from a prolonged impact from the COVID-19 pandemic or a very poor hydrological season--combined with a sharp depreciation of the Brazilian real.

Upside scenario

We could revise the outlook to stable if the shareholder's fiscal conditions improve. We could also revise the outlook to stable if specific measures are implemented that effectively limit the state's ability to interfere in the company.

We could revise the company's SACP upwards if it consistently has debt to EBITDA below 2.0x and FFO to debt near 35%, mostly because of improving operating performance, lower debt, and a significant reduction of its foreign currency debt exposure.

Ratings Score Snapshot

Issuer Credit Rating:

Global scale: BB-/Negative/--

National Scale: brAAA/Negative/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

Likelihood of government support: Moderately high

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Credit FAQ Discusses To What Degree The Fiscal Package Will Help Brazilian Local And Regional Governments, June 9, 2020
- Full Analysis: Companhia de Saneamento Basico do Estado de Sao Paulo, April 20, 2020

Ratings List

Ratings Affirmed

Companhia de Saneamento Basico do Estado de Sao Paulo

Analytical Factors	bb+
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Companhia de Saneamento Basico do Estado de Sao Paulo

Senior Unsecured	BB-
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Senior Unsecured	brAAA
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Ratings Affirmed; CreditWatch/Outlook Action

	To	From
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Companhia de Saneamento Basico do Estado de Sao Paulo

Issuer Credit Rating	BB-/Negative/--	BB-/Stable/--
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Brazil National Scale	brAAA/Negative/--	brAAA/Stable/--
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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.standardandpoors.com for further information. Complete ratings

information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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