



RATING ACTION COMMENTARY

Fitch Affirms Sabesp's Ratings; Outlook Stable

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Fitch Ratings - Rio de Janeiro - 19 Apr 2023: Fitch Ratings has affirmed Companhia de Saneamento Basico do Estado de São Paulo's (Sabesp) Local Currency (LC) Issuer Default Rating (IDR) at 'BB+' and Foreign Currency (FC) IDR at 'BB'. The agency has also affirmed the National Scale Rating 'AAA(bra)' for the company and its unsecured debenture issuances. The Rating Outlook is Stable.

Sabesp's ratings reflect the solid fundamentals of the water/wastewater industry in Brazil and the issuer's solid business profile. Fitch expects the company to maintain conservative net leverage and robust liquidity, despite forecasted negative FCFs. The analysis incorporates Fitch's view of the company's ownership exposure to its majority shareholder, state of Sao Paulo (BB-/Stable). This limits the LC IDR up to two notches from the parent's rating, per Fitch's criteria, but currently is not a constrain. The FC IDR is capped by Brazil's country ceiling 'BB'.

KEY RATING DRIVERS

Porous Linkage Assessment: Sabesp's assessment of its Standalone Credit Profile (SCP) is commensurate with an 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 limited 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 of 'bb+'. Fitch considers the strength of linkage between them as moderate and the incentive to support as weak to moderate. In addition, the company presents porous legal ring-fencing 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 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 changes 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 has the largest GDP and population in the country.

High Revenue Predictability: The approved required revenue until 2024 improves Sabesp's cash flow predictability. The company will implement a tariff increase of 9.6% in May 2023 that includes 3.8% of regulatory adjustment to compensate for lower effective revenue, compared with minimal required regulatory revenue during the prior 12 months. Sabesp's required revenue for the regulatory year May 2023-April 2024 is BRL20.0 billion (inflation adjusted). The company 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 required revenue.

EBITDA Margin Above Peers: Fitch expects SABESP to keep its EBITDA margin in the 38%-44% range, which is high and compares favorably with its state-owned peers. In the base case scenario for the rating, the company's EBITDA will reach BRL7.2 billion in 2023 (38% margin -- pressured by non-recurring cost spending), and BRL8.8 billion in 2024 (44% margin). Total volume billed should increase by 1.5% on average annually during this period, given the increasing number of connections. The base case scenario assumes manageable levels of water losses and delinquency and no water supply restrictions as reservoir levels are currently high.

Heavy Investment Cycle: Sabesp's large capex program should pressure its FCF in the coming years. Fitch projects the issuer's cash flow from operations (CFFO) at BRL3.4 billion in 2023, resulting in a negative FCF of BRL2.6 billion after investments of BRL5.1 billion and dividends of BRL899 million. Annual FCF in 2024-2025 is expected to average negative BRL1.2 billion, after robust average CFFO of BRL5.0 billion, investments of BRL5.7 billion and expected dividends of BRL508 million on average per year. Working capital pressure should ease as the company implements efficiency commercial measures.

Low Leverage: The leverage metrics of Sabesp 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 limited to 3.0x and 2.6x, respectively, which are conservative for the industry. Fitch forecasts gross leverage of 2.9x and net leverage of 2.5x in 2023 and below this level thereafter, compared with an annual average of 2.6x and 2.1x, respectively, from 2019 to 2022.

New Regulatory Environment Neutral: Sabesp's ratings do not incorporate a major impact of recent regulatory changes in its operations and cash flow. Fitch sees some setback in the recent flexibility and extension of the deadline for inefficient state public companies to prove the economic and financial capacity to continue providing the water/wastewater service in the municipalities they operate. The increase in the private sector's participation should occur primarily at the expense of more inefficient state-owned companies or municipal operators, which is not the case for 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 and FC IDRs BB/Stable), 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; FC IDR BB/Stable) and 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 LC IDRs BB-/Stable), a GRE in Namibia that has its ratings constrained by the sovereign given Fitch's view of strong strength of linkage and incentive to support between the company and the government. NamWater SCP is 'bbb-' given strong sector positioning, predictable cash flows and a strong liquidity profile.

KEY ASSUMPTIONS

--Total volume billed growth of 1.3% in 2023, supported by growth of connections and overall stable volume/connection consumption;

--Total annual tariff increase of 9.6% in May 2023, 2.5% in 2024 and in line with inflation estimates, resulting in revenues within regulatory required revenue range;

--Average annual capex of BRL5.5 billion in 2023-2025;

--Dividends of BRL899 million in 2023 and a payout ratio of 29% of net profits thereafter.

RATING SENSITIVITIES

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

--A positive rating action on the FC IDR depends on the same movement on the sovereign rating;

--A positive rating action on the LC IDR depends on FCF at least neutral to slightly negative associated with the same movement on the rating of the state of São Paulo;

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

--Negative rating action 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 key factors for the rating, as they enable the company to manage its forecast negative FCF and refinancing needs. Sabesp's cash position of BRL3.5 billion at the end of 2022 covered its short-term debt of BRL2.2 billion by 1.6x. Total debt of BRL18.9 billion had an extended maturity profile and consisted primarily of funding from multilateral agencies of BRL7.4 billion, BRL8.2 billion in debenture issuances, and BRL2.9 billion from Caixa Economica Federal (Caixa) and Banco Nacional de Desenvolvimento Economico e Social (BNDES). Foreign currency debt corresponding to 15% of total debt represents moderate exposure risk to currency volatility. At the end of 2022, only Caixa's and BNDES's debt was secured by receivables that represents less than 0.4x its EBITDA and does not pressure the ratings of unsecured issuances.

ISSUER PROFILE

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. The company directly supplies water to 28.0 million people and sewage collection services to 24.7 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

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 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

[Government-Related Entities Rating Criteria \(pub. 30 Sep 2020\)](#)
[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)
[Parent and Subsidiary Linkage Rating Criteria \(pub. 01 Dec 2021\)](#)
[Corporate Rating Criteria \(pub. 28 Oct 2022\) \(including rating assumption sensitivity\)](#)

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

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Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP)

EU Endorsed, UK Endorsed

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