



## RATING ACTION COMMENTARY

# Fitch Upgrades SABESP's LC IDR to 'BB+'; Upgrades National Scale Rating to 'AAA(bra)'

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Fitch Ratings - Rio de Janeiro - 26 Apr 2021: Fitch Ratings has upgraded Companhia de Saneamento Basico do Estado de Sao Paulo's (SABESP) Local Currency (LC) Issuer Default Ratings (IDRs) to 'BB+' from 'BB', and its National Scale Rating to 'AAA(bra)' from 'AA(bra)'. Fitch also affirmed the Foreign Currency IDR at 'BB'. The Rating Outlook on the Foreign Currency IDR remains Negative, while the Outlook on the Local Currency IDR and National Scale Rating is Stable.

The upgrade reflects SABESP's strengthened credit profile after the third tariff review cycle that supports its forecast cash flow from operations (CFFO) increase through the regulatory cycle 2021-2024, with EBITDA margins above 45% during 2022-2024 and positive FCF. The company expected sustained net leverage below 2.0x and the successful reduction of its FX debt exposure in 2020 were also incorporated.

The ratings consider the solid fundamentals of the water/wastewater industry under resilient demand, as well as SABESP's robust liquidity position, manageable debt maturity schedule and its condition as a state-owned company. The Negative Outlook for the Foreign Currency IDR follows Brazil's Sovereign Outlook.

Feedback

## KEY RATING DRIVERS

**Tariff Review Increases Predictability:** The approval for overall tariff increase of 7.1% in May 2021 and the required regulatory revenue of BRL17.5 billion from May 2021 to April 2022, with gradual increase to BRL18.7 billion from May 2024 to April 2025, should support growth of SABESP's revenue during this regulatory cycle. The company's required revenue is 21% above 2020 and is now protected by the range of +/-2.5% band within the next four years. The company is to receive/return in the following year through tariff adjustment if effective revenues falls outside this range. This condition provides further predictability for its results irrespective of volume billed, with potential frustrations on revenues accounted during a 12-month period, when compared with the regulatory number, being compensated on the following period.

**Higher EBITDA Margins:** SABESP's regulatory required revenue supports stronger EBITDA and EBITDA margins in 2022-2024 at above 45%. The base case scenario assumes no material impact on SABESP's EBITDA and cash flow generation coming from potential higher water losses or delinquency, as well as significant lower volumes billed, due to increased tariffs. EBITDA in 2021 should be stable at BRL6.2 billion, with EBITDA margin reduction to 40% given projected cost pressure and low total volume growth of 0.5%. EBITDA margin should increase to 46%-48% in the following three years supported by revenue growth, resulting in BRL8.3 billion-BRL9.0 billion annual EBITDA in the period.

**Positive FCF from 2022:** Fitch forecasts SABESP's CFFO at BRL3.4 billion in 2021 resulting in negative FCF of BRL662 million, pressured by capex of BRL3.7 billion and BRL272 million of dividends. 2022-2024 FCF should position at BRL239 million positive on annual average favored by stronger CFFO of BRL5.4 billion of annual average despite total BRL11.3 billion in capex and BRL2.6 million in dividends in the period. The base case scenario assumes manageable working capital requirements despite potential delinquency pressure with higher tariffs particularly to the residential client segment as approved on the new tariff structure.

**Conservative Leverage and Lower FX Exposure:** SABESP's net leverage should remain conservative and below 2.5x over the next three years — including 2.3x in 2021, which is low for the industry and for its IDRs — supported by stronger EBITDA through the cycle. Net debt/EBITDA was 2.1x at YE2020. The company has successfully reduced its foreign-currency debt exposure to 21%, from 48% in 2019, given its strategy for new debt issuances in local currency to mitigate FX volatility impact. This mitigates concerns related to financial covenants and during periods of high FX debt maturity.

**Reduced Business Risk:** SABESP's credit profile benefits from resilient demand and from its low business risk, with its near-monopolistic position as a provider of an essential

service within its operational area, as well as its economies of scale as the largest basic sanitation company in the Americas by number of customers. The assessment also reflects SABESP's still-developing regulatory environment, the intrinsic hydrological risk of its business and the political risk associated with its position as a state-owned company subject to potential changes in management and strategy after each state of Sao Paulo election. SABESP's activity in the state of Sao Paulo, which has the country's largest GDP and population, is viewed as positive.

**Stand Alone Credit Profile:** Per Fitch's Government-Related Entities Rating Criteria, Fitch assesses SABESP on a standalone basis. This approach is supported by Fitch's perception of a reduced incentive for SABESP's major shareholder to provide support if needed, given minimal financial implications for the state of Sao Paulo if SABESP defaults, and limited evidence of a record or expectations for the state to provide support. SABESP's activities are independent from its major shareholder, both financially and operationally. A default should have only moderate sociopolitical implications for the state, despite the assessment as strong of its status, ownership and control by the state.

**New Regulatory Environment:** The base case scenario incorporates no major impact on SABESP's operations and cash flow from the recent regulatory changes. Discussions about regulatory guidelines for national water/wastewater should facilitate greater participation by private companies and enhance the industry's investment capacity. Private participants account for around 6% of the industry's market share and their growth should occur mainly at the expense of highly inefficient state-owned companies or local municipality 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 capital structure when compared with Aegea Saneamento e Participacoes S.A. (Local Currency [LC] IDR BB/Stable and Foreign Currency [FC] IDR BB/Negative), which has moderate leverage, reflecting its growth strategy. SABESP's strengthened CFFO generation capacity after 3rd tariff revision also supports the one notch difference on the LC IDR, despite exposure to political risk given its status as a state-owned company. 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. Both SABESP and Aegea have similar and strong EBITDA margins.

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

--Marginal total volume billed growth of 0.5% in 2021;

--Total annual tariff increase of 7.1% on May 2021;

--Effective net revenue in line with 97.5% of regulatory required revenue from May 2022 onwards;

--2022 and 2023 net revenues include increase of BRL1.4 billion (pro rata) related with the difference of effective net revenue and regulatory required net revenue from May 2021 to April 2022;

--Average annual capex of BRL3.8 billion in 2021-2023;

--Dividends of BRL272 million in 2021 and a payout ratio of 30% of net profits thereafter.

## RATING SENSITIVITIES

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

--Positive rating actions on the LC and FC IDRs depend on positive actions 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 and LC IDRs;

- 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, sound CFFO and proven financial market access is crucial for the company to manage expected negative FCF in 2021 and to refinance debt maturities. SABESP's cash and equivalents of BRL3.8 billion at YE2020 covered short-term debt of BRL3.0 billion by 1.3x. SABESP's total debt of BRL17.2 billion at YE2020 presented a lengthened maturity profile and consisted mainly of multilateral agency loans of BRL6.1 billion and BRL6.6 billion in debenture issuances. From total debt, BRL3.5 billion, or 21%, were linked to FX rates without any hedge protection, which represents moderate FX volatility exposure risk. Only BRL2.8 billion of total debt at YE2020 was secured by future flow of receivables linked with Banco Nacional de Desenvolvimento Economico e Social (BNDES) and Caixa Economica Federal loans, which do not pressure unsecured rated issuances.

## **SUMMARY OF FINANCIAL ADJUSTMENTS**

- Construction revenue is excluded from total revenues;

--For 2020 and 2019, 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](http://www.fitchratings.com/esg).

## RATING ACTIONS

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

[VIEW ADDITIONAL RATING DETAILS](#)

Feedback

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## APPLICABLE CRITERIA

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

[Metodologia de Rating de Entidades Vinculadas a Governos \(pub. 06 Oct 2020\)](#)

[Corporate Rating Criteria \(pub. 21 Dec 2020\) \(including rating assumption sensitivity\)](#)

[Metodologia de Ratings Corporativos \(pub. 21 Dec 2020\)](#)

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

[Metodologia de Ratings em Escala Nacional \(pub. 22 Dec 2020\)](#)

## APPLICABLE MODELS

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

## Corporate Monitoring &amp; Forecasting Model (COMFORT Model), v7.9.0 (1)

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

EU Endorsed, UK Endor:

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