

Rating Action: Moody's upgrades Copasa to Ba2/Aa3.br; outlook changed to stable

24 Jan 2020

Sao Paulo, January 24, 2020 -- Moody's America Latina., ("Moody's") has today upgraded the Corporate Family Ratings (CFR) and senior unsecured debt ratings assigned to Companhia de Saneamento de Minas Gerais ("Copasa" or "the company") to Ba2 from Ba3 on the global scale and to Aa3.br from A1.br on Brazil's national scale (NSR). The ratings outlook was changed to stable from positive. At the same time Moody's has raised Copasa's baseline credit assessment (BCA) to ba2 from ba3.

RATINGS AFFECTED:

.Issuer: Companhia de Saneamento de Minas Gerais

Corporate Family Ratings upgraded to Ba2 (Global Scale) and Aa3.br (Brazilian National Scale) from Ba3/A1.br

Senior unsecured debt ratings upgraded to Ba2/Aa3.br (Global Scale and Brazil National Scale, respectively) from Ba3/A1.br

Outlook: changed to stable from positive

RATINGS RATIONALE

The rating upgrade was prompted by solid operating performance that has led to a maintenance of strong credit metrics -- illustrated by key ratios of funds from operations (FFO) interest coverage of 6.4x and FFO to Debt exceeding 37% for the last twelve months ended September 2019 -- and a solid liquidity profile. Copasa's operating performance is mainly driven by the successive tariff increases received on the back of the company's first tariff review in 2016-2017, as well as efficiency gains which contributed to the 4.31% and 8.4% tariff increases granted by the regulator in June 2018 and June 2019, respectively. Moody's considers that the 2018 and 2019 tariff adjustments were in line with parameters that were set during the tariff review process, which supports the agency's view of a continued evidence of predictable regulatory framework under which Copasa operates. That said, we note the relatively short track record of the tariff mechanism as the company is still in the middle of its first tariff cycle (2017-2021).

The upgrade also considers Copasa's more robust corporate governance structure, with the creation of an audit committee and a leverage-base dividend distribution policy which in Moody's view better protects Copasa's credit profile against the risk of political interference from its controlling shareholder, the state of Minas Gerais (B2 stable). While the Minas Gerais state government retains the ability to exert material influence over the direction of the company through their control over board decisions, including executive management nomination, the state's influence has been very limited over the recent years, even as the state's liquidity profile continued to deteriorate. This supports the larger distance between the rating of the company and that of its controlling parent.

Copasa's Ba2/Aa3.br corporate family ratings reflect (i) strong business profile with low demand risk and high predictability over cash flow, (ii) attractive concessions are presenting growth potential given the large portion of municipalities under water concession contracts but without access to sewage services and (iii) moderate leverage with a reported Net Debt / EBITDA metric of 1.8x in September 2019. On the other hand, the ratings also consider (i) the erosion of water consumption pattern, which reduces the scope for growth, as the company has yet to restore its billed volumes which peaked in 2014, (ii) significant capital expenditures needed to expand coverage of services and reduce water loss rates, and (iii) recent increase in bad debt provisions, in particular from the public sector.

RATING OUTLOOK

The stable outlook incorporates the view that Copasa's credit metrics will remain adequately positioned for the Ba2 category, as reflected in FFO to Net Debt in the 39%-44% range and FFO interest coverage of 6.0x-6.8x.

WHAT COULD CHANGE THE RATING UP/DOWN

Copasa's global scale rating is constrained by Brazil's government bond rating (Ba2 stable), given the highly regulated nature of the water sector and exposure to the same operating environment as the sovereign; therefore, a rating upgrade is unlikely at this time. Conversely, a perception of a material change in the regulatory framework under which Copasa operates, a disruptive political interference in the normal course of its business and a deterioration in the company's credit metrics, such that FFO to Net Debt ratio falls below 15% and FFO interest coverage ratio remains sustainably below 3.0 times, could prompt a rating downgrade.

The methodologies used in these ratings were Government-Related Issuers published in June 2018, and Regulated Water Utilities published in June 2018. Please see the Rating Methodologies page on www.moodys.com.br for a copy of these methodologies.

Headquartered in Belo Horizonte, in the state of Minas Gerais, Brazil, Copasa is the second largest state water and sewage company in Brazil, serving 5.3 million water units and 3.7 million sewage units, spread across 641 municipalities through its 55,624 km water distribution and 28,031 km sewage collection networks (as of September 2019). Copasa is controlled by the state of Minas Gerais, which owns 50.04% of its voting shares while the remaining shares are listed on the domestic B3's stock exchange. Most of the floated shares are held by foreign investors.

Copasa has concessions to operate water services in 641 municipalities and sewage services in 311 of them. Copasa provides water and sewage services to the northern region of the state through its wholly-owned subsidiary, COPANOR, which accounts for less than 1% of consolidated revenues. In the last twelve months ended in September 2019, Copasa reported net operating revenues (excluding construction revenues) of about BRL4.5 billion, and EBITDA (as reported by the company) of BRL1.6 billion.

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in May 2016 entitled "Mapping National Scale Ratings from Global Scale Ratings". While NSRs have no inherent absolute meaning in terms of default risk or expected loss, a historical probability of default consistent with a given NSR can be inferred from the GSR to which it maps back at that particular point in time. For information on the historical default rates associated with different global scale rating categories over different investment horizons, please see http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1174796.

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