



RATING ACTION COMMENTARY

Fitch Affirms COMGAS's IDR at 'BB'; Outlook Negative

Wed 19 May, 2021 - 2:58 PM ET

Fitch Ratings - Rio de Janeiro - 19 May 2021: Fitch Ratings affirmed Companhia de Gas de Sao Paulo - COMGAS's Long-Term Foreign Currency Issuer Default Rating (IDR) at 'BB', Local Currency IDR at 'BBB-' and National Long-Term Rating at 'AAA(bra)'. The Outlook is Negative for the IDRs and Stable for the National Long-Term Rating.

The ratings reflect the low to moderate business risks of the natural gas distribution business in Brazil and COMGAS's historically robust financial profile, significant cash flow from operations (CFFO) and favourable growth prospects. COMGAS's business profile benefits from its operations in the state of Sao Paulo, the most economically important in Brazil, and its long-term concession, with nonmanageable costs pass-through that protects its cash flows. The analysis assumes recontracting risks of maturing gas supply agreements in 2021 and 2023 as manageable and no major changes in the company's credit profile in the rating horizon due to the new regulatory framework in the country. The Negative Outlook for the IDRs reflects the same Outlook for the sovereign rating.

KEY RATING DRIVERS

Resilient and Sound EBITDA: COMGAS should sustain strong EBITDA and adjusted EBITDA margin in the next three years, being BRL2.4 billion in 2021 and BRL2.6 billion in 2022, supported by adequate tariff increases, maintenance of operating and cost efficiencies, expansion of the client base and growing volumes billed. The adjusted EBITDA margin, which excludes gas acquisition costs from net revenues on the calculation, is expected at around 83% in the period. The assumption considers margin

contribution of BRL0,62/m³ and total volume billed growth of 6% in 2021 to 4.5 billion of m³ as compared with 2020, when volume decreased by 6% (ex-thermo clients) notwithstanding better client segment mix. Considering the last 12 months (LTM) ended on March 2021, COMGAS's EBITDA was BRL2.4 billion, with adjusted EBITDA margin of 85%.

New Regulatory Environment is Neutral: The ratings assume neutral impact on COMGAS's credit profile coming from the new regulatory environment. Higher gas supply competition in the medium term and more transparent gas industry rules should reduce gas prices to end consumers, stimulate demand and support growth of operations. Notwithstanding, the new regulatory environment increases COMGAS exposure of large clients leaving the company's customer base by switching gas supplier. Despite the fact that COMGAS will continue to receive a remuneration for its distribution assets, this may not be enough to offset the cash flow generation impact on lower volume billed. The company's relevant scale of operations should allow COMGAS to be competitive on gas purchase prices and mitigate this risk.

FCF Pressured by Dividends: Forecasted strong dividend distributions and capex plan during 2021-2023 will make COMGAS's FCF negative, at BRL501 million per year on average, including negative BRL472 million in 2021. CFFO should remain robust at BRL1.6 billion-BRL1.7 billion annually. The base case scenario assumes annual average dividend payments of BRL1.1 billion with 100% pay-out ratio and investments of BRL1.0 billion. COMGAS's ratings considers its standalone credit profile due to a weak linkage between the company and its ultimate parent Cosan S.A. (Cosan - Foreign Currency IDR 'BB'/Negative, Local Currency IDR 'BB+ '/Stable and National Long-Term Rating 'AAA(bra)'/Stable). There is no legal linkage and the group's access to COMGAS's cash is limited to dividend distributions.

Conservative Leverage: COMGAS's net leverage is expected to not exceed 2.0x during 2021-2023, which is conservative if considering its low to moderate business risks. COMGAS is Brazil's largest natural gas distribution company in volume billed and is subject to natural gas consumption volatility within the industrial segment as it represents around 50% of its EBITDA generation. The segment's performance is highly linked with GDP and results in moderate cash flow variation. COMGAS's competitive, manageable expense structure and efforts to expand its residential and commercial client bases, with higher profitability, mitigate the effects of industrial segment volatility.

Manageable Supply Risk: Fitch assumes no gas supply disruptions for COMGAS in the coming years, even though the supply contracts with Petroleo Brasileiro S.A. (Petrobras) will mature in December 2021 and December 2023. Positively, COMGAS has the option to renew its supply agreement until 2027 at its discretion, which mitigates medium-

term supply risks. Single-supplier concentration risk remains, which is a common industry characteristic in Brazil, but is supposed to change with the new regulation. The natural gas purchase is the company's main cost and considered as nonmanageable, with pass through to tariffs based on contract clauses. Gas demand is influenced by GDP and price competitiveness, and take-or-pay and ship-or-pay clauses of 80% and 100%, respectively, may pressure cash flow during unfavorable macroeconomic scenarios.

DERIVATION SUMMARY

COMGAS's credit profile compares favorably with Companhia de Saneamento Basico do Estado de Sao Paulo (SABESP; Local Currency IDR BB+/Stable), a water/wastewater utility company that also operates in the state of Sao Paulo, mainly due to SABESP's state-owned condition that incorporates inherent political risk. Both companies have sound capital structures and liquidity profiles in addition to proven financial market access. In the case of Transmissora Alianca de Energia Eletrica S.A. (Taesa; Local Currency IDR BBB-/Negative), a Brazilian power transmission company, COMGAS's lower leverage is counterbalanced by Taesa's lower regulatory and business risks, with no volumetric exposure, leading to more predictable CFFO. The Foreign Currency IDR is also BB/Negative for SABESP and Taesa

Promigas S.A. E.S.P. (Local and Foreign Currency IDR BBB-/Stable) has a strong business position in Colombia and predictable cash flow generation, but its gross leverage of around 4.0x-4.5x is higher than COMGAS's, at around 2.0x-2.5x. However, Promigas's business profile benefits from diversification within natural gas transportation and distribution; COMGAS only distributes gas and can face demand volatility.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

--Total volume billed, excluding the thermo power generation segment, growth of 6% in 2021, with an annual average increase of 2.3% thereafter, in line with Fitch's GDP projections for Brazil;

--Dividend payout ratio of 100% of distributable net profit;

--Annual average capex of BRL1.0 billion in 2021-2023;

--Annual contribution margin increases in line with Fitch's inflation estimates and adjusted by an efficiency factor of 0.52%.

RATING SENSITIVITIES

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

--Positive rating actions are unlikely; a revision of the Negative Outlook to Stable of the FC and LC IDR could occur with an identical revision to the sovereign's Outlook.

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

--Expectation of a sustainable increase in net debt/EBITDA to above 3.0x;

--Fitch's perception of increased regulatory or gas supply risk;

--A sharp decline in volumes;

--Deterioration of the company's liquidity profile;

--A downgrade of the sovereign rating would trigger a downgrade for the IDRs.

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

Robust Liquidity Position: COMGAS's credit profile benefits from robust liquidity position and a proven access to credit. The company registered a comfortable cash position of BRL1.9 billion by the end of March 2021 equivalent to 7.3x its short-term debt. Nevertheless, COMGAS presents inadequate concentration of debt maturity in 2022 and 2023, BRL2.3 billion and BRL1.5 billion, respectively, and should deal with negative FCFs. Fitch estimates the company to lengthen these maturities within the next months. COMGAS total debt of BRL5.7 billion consisted mainly of BRL4.1 billion of debentures and BNDES loans of BRL1.1 billion.

SUMMARY OF FINANCIAL ADJUSTMENTS

--Construction revenues are excluded from net revenues.

--Debt adjusted with hedging derivatives.

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 Gas de Sao Paulo - COMGAS	LT	BB Rating Outlook Negative	Affirmed	BB Rating Outlook Negative
	IDR			
	LC	BBB- Rating Outlook Negative	Affirmed	BBB- Rating Outlook Negative
	LT			
	IDR			

ENTITY/DEBT	RATING			PRIOR
	Natl LT	AAA(bra) Rating Outlook Stable	Affirm ed	AAA(bra) Rating Outlook Stable
● senior unsecured	Natl LT	AAA(bra)	Affirm ed	AAA(bra)

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Feedback

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APPLICABLE CRITERIA

[Parent and Subsidiary Linkage Rating Criteria \(pub. 26 Aug 2020\)](#)

[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 & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

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Companhia de Gas de Sao Paulo - COMGAS

EU Endorsed, UK Endorsed

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