



RATING ACTION COMMENTARY

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

Tue 26 May, 2020 - 5:24 PM ET

Fitch Ratings - Rio de Janeiro - 26 May 2020: Fitch Ratings has affirmed Companhia de Gas de Sao Paulo - COMGAS's Long-Term Foreign Currency (FC) Issuer Default Rating (IDR) at 'BB', Local Currency (LC) IDR at 'BBB-' and National Long-Term Rating at 'AAA(bra)'. The Outlook is Negative for the IDRs and Stable for the National Scale Rating.

The rating action reflects Fitch's expectation that COMGAS will sustain its credit profile despite the indirect negative impact of the coronavirus on its operations. Fitch estimates a reduction in total volume billed of 13% during 2020, driven by lower volume on industrial and commercial clients. The estimated moderate higher volume for residential customers with a higher average tariff should partially alleviate the impact on expected lower EBTIDA generation during the period. Fitch estimates no cash burn from operations during 2020. The company's sound financial structure and liquidity profile provide enough buffer to support the expected challenging operating scenario. Fitch assumed gradual recovery of gas volume billed from 2021 onward.

COMGAS's ratings are sustained by the solid fundamentals of its natural gas distribution business and historically robust financial profile with reduced leverage, strong liquidity profile and significant cash flow from operations

(CFFO). COMGAS's business profile benefits from its operations in the state of Sao Paulo, the most economically significant state in Brazil, and from the company's long-term concession agreement, which includes clauses with nonmanageable cost pass-through that protect its cash flow generation.

The company has favorable growth prospects in the medium and long term given the expectation of gas-distribution network and customer base expansions that presents low penetration. Fitch believes gas should continue to be competitive compared with alternatives, which benefits billed volume increases. Fitch assumes the company will be able to continually recontract its gas supply needs before existing agreements expire, with potential contractual changes not materially affecting COMGAS's cash flow generation. Fitch incorporates no major changes in the company's credit profile due to regulatory issues. COMGAS's ratings consider the company's ownership by the Cosan group, whose main shareholder is Cosan S.A. (BB/Negative). However, the group's access to COMGAS's cash is mainly limited to dividend distributions, given its concessionaire status.

COMGAS's FC IDR is capped by the Brazilian country ceiling of 'BB', and Fitch considers a three-notch difference between the company's LC IDR and the sovereign IDR (BB-/Negative) as appropriate for a regulated sector. The Negative Outlook for the IDRs is aligned with the Outlook of the sovereign rating. The Stable Outlook for the National Scale rating reflects Fitch's expectations that the natural gas distribution industry will preserve strong fundamentals and that COMGAS will sustain robust credit metrics, with net adjusted leverage below 2.5x over the next three years.

KEY RATING DRIVERS

Volume Billed Decrease: Fitch estimates COMGAS industrial clients will register a 14% volume reduction in 2020 compared with 2019, which should drive the 13% reduction in total volume billed for the year, considering the industrial segment accounts for 80% of the company's total volume. Fitch assumed lower volume billed to the commercial and vehicles segments of 25% and 28%, respectively, during 2020. An estimated increase of 6% on volume billed to residential customers with a higher average tariff should partially mitigate the negative impact on COMGAS's EBITDA generation in 2020 from the expected reduction in the volume of operations. The base case scenario considers some recovery in the following years, with a 3% increase in 2021.

Cash Generation Remains Sound: Fitch estimates COMGAS will sustain strong normalized EBITDA in the next three years, despite a decrease to BRL1.9 billion in 2020 and BRL2.0 billion in 2021. EBITDA results are based on an expectation for adequate tariff increases, maintenance of operating and cost efficiencies, and expansion of its client base. Normalized EBITDA is adjusted for higher or lower nonmanageable costs than those in the tariff. Under the concession agreement, these differences are incorporated into the next tariff-adjustment process. According to IFRS, the company's EBITDA was BRL2.5 billion in 2019 per Fitch's methodology, benefited by BRL295 million of current account balance inflow.

FCF Pressured: Fitch estimates strong dividend distribution and increased capex during 2020-2022 will make COMGAS's FCF negative, at approximately BRL551 million per year on average in the same period, and BRL762 million in 2020. Fitch expects manageable working capital pressure, deriving from an expected increase of delinquency during 2020. The base case scenario assumes annual average dividend payments of BRL955 million and investments of BRL950 million. The expectation of robust CFFO generation at BRL1.2 billion-BRL1.5 billion annually during this period should mitigate FCF pressure.

Low Leverage Remains: Fitch expects COMGAS's net leverage to remain low and consistent with the LC IDR, despite lower EBITDA, higher capex and strong dividend distributions. According to Fitch's base case scenario, net debt/EBITDA will not exceed 2.5x, and will be 2.3x in 2020. COMGAS's average total debt/EBITDA and net debt/EBITDA during 2017-2019 were 2.3x and 1.2x, respectively, according to Fitch's methodology.

Low to Moderate Business Risk: COMGAS is Brazil's largest natural gas distribution company in terms of volume billed and is subject to natural gas consumption volatility within the industrial segment, its most relevant. This segment's performance is highly linked with GDP and results in moderate cash flow variation. COMGAS's competitive, manageable cost structure and continued efforts to expand its residential and commercial client base, with higher profitability, nevertheless mitigate the effect of industrial segment volatility.

Manageable Supply Risk: Fitch assumes no gas supply disruptions for COMGAS in the coming years, despite the supply contract with Petroleo Brasileiro S.A. (Petrobras) maturing in 2021. 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. The purchase of natural gas, which is the company's main cost, is considered nonmanageable and is passed through to

tariffs based on contract clauses. Gas demand is influenced by GDP and price competitiveness. However, switching costs in some industrial segments represent a barrier to alternative sources of energy.

DERIVATION SUMMARY

COMGAS's credit profile compares favorably with Companhia de Saneamento Basico do Estado de Sao Paulo (Sabesp, BB/Negative), a water/wastewater utility company that also operates in the state of Sao Paulo, as Sabesp has significant unhedged FX debt exposure, political risk and a higher level of CFFO committed to capex. However, both companies present sound capital structures and sound liquidity profiles. In the case of Transmissora Alianca de Energia Eletrica S.A. (Taesa, BB/Negative), a Brazilian power transmission company, COMGAS's lower leverage is counterbalanced by Taesa's lower regulatory and business risks, given no volumetric exposure leading to more predictable CFFO. Promigas S.A. E.S.P. (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' business profile benefits from diversification within natural gas transportation and distribution, compared with COMGAS, which only distributes gas and can face demand volatility. Promigas' IDR also incorporates its operation in a country with a better operating environment than COMGAS's.

KEY ASSUMPTIONS

--Total volume billed decreases (excluding the thermo power generation segment) by 13% in 2020, with an annual average increase of 3% thereafter, in line with Fitch's GDP estimation;

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

--Annual average capex of BRL950 million in 2020–2022;

--Annual contribution margin increase 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 could occur if the same occurs with the sovereign rating.

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

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

--Fitch's perception of regulatory and/or gas supply risk deterioration;

--Sharp decrease in volume billed beyond Fitch's expectations;

--Deterioration of the company's liquidity profile;

--A downgrade of the sovereign rating would trigger a downgrade for the FC and LC 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 and a manageable debt maturity schedule. Fitch estimates the company to have a

comfortable cash position of BRL3.0 million-BRL3.5 billion in mid-May, which includes BRL1.5 billion of debt issuance during April and BRL560 million of Banco Nacional de Desenvolvimento Economico e Social (BNDES) reimbursement of realized capex. The company's short-term debt was BRL781 million by end 2019, with around BRL600 million to be amortized between May 2020 and December 2020. Fitch expects the company to disburse an additional BRL400 million with BNDES in 2H20 to partially support its capex during the following quarters. COMGAS's financial flexibility benefits from a proven track record in accessing local debt and capital markets, with a suitable cost of funding during the last five years, which mitigates the expected negative FCF in coming years.

SUMMARY OF FINANCIAL ADJUSTMENTS

--Construction revenues are excluded from net revenues.

--Debt adjusted with hedging derivatives.

--BRL802 million excluded from 2018 EBITDA related to nonrecurrent indemnities and tax recovery.

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

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING
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ENTITY/DEBT	RATING		
Companhia de Gas de Sao Paulo - COMGAS	LT IDR	BB	Affirmed
	LC LT IDR	BBB-	Affirmed
	Natl LT	AAA(bra)	Affirmed
● senior unsecured	Natl LT	AAA(bra)	Affirmed

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[National Scale Ratings Criteria \(pub. 18 Jul 2018\)](#)

[Metodologia de Ratings em Escala Nacional \(pub. 17 Aug 2018\)](#)

[Corporate Rating Criteria \(pub. 01 May 2020\) \(including rating assumption sensitivity\)](#)

[Metodologia de Ratings Corporativos \(pub. 08 May 2020\)](#)

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 \(1\)](#)

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