MOODY'S
INVESTORS SERVICE

Credit Opinion: Companhia de Saneamento do Paraná - SANEPAR

Global Credit Research - 13 Aug 2015

Curitiba, Brazil

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	Ba1
Senior Unsecured -Dom Curr	Ba1
NSR Senior Unsecured	Aa2.br
NSR LT Issuer Rating	Aa2.br

Contacts

Analyst	Phone
Marcos, De Oliveira/Sao Paulo	55.11.3043.7300
William L. Hess/New York City	1.212.553.1653

Key Indicators

Companhia de Saneamento do Paraná - SANEPAR

	6/30/2014 (L)	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Adjusted Interest Coverage	6.4x	8.1x	9.2x	6.6x	4.4x
FFO Interest Coverage	6.9x	8.2x	9.0x	7.1x	5.4x
Net Debt / Regulated Assets Value	46.1%	43.5%	36.3%	33.7%	35.6%
Debt / Capitalisation	41.1%	39.9%	44.5%	42.2%	41.8%
FFO / Net Debt	30.2%	32.4%	38.0%	36.0%	26.4%
RCF / Capex	0.7x	0.7x	1.1x	1.5x	0.9x

Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Relatively stable cash flow based on long-term concessions signed with municipalities

- Strong credit metrics for the rating category

- Track record of political interference

- Underdeveloped regulatory framework

- Sizeable capital expenditure program

- Resilient access to BNDES, Caixa and local capital markets

Corporate Profile

Headquartered in Curitiba in the Brazilian state of Parana, Sanepar was founded in 1963. As of December 31, 2014, Sanepar had more than 2.8 million water connections and higher than 1.7 million sewage connections to provide treatment and distribution of water to approximately 10.8 million consumers and sewage service to 7.1 million consumers in 345 municipalities in the state of Paraná and one municipality in the state of Santa Catarina, which represents approximately 86% of the total municipalities in the State of Paraná. From the 346 municipalities in which Sanepar operates about 7.5% are in the process of being renewed because they have already expired, approximately 4.9% will expire from 2014 to 2020 and 87.6% will expire after 2020.

Sanepar is controlled by the State of Paraná (Ba1, negative) which owns 75% of SANEPAR's voting shares and by Domino Holdings S.A. (not rated) which owns 24.7%, and others 0.3%. The company has also preferred shares which are spread out among State of Paraná (43%), Domino Holdings S.A. (0.3%), Companhia Paranaense de Energia - Copel (14.9%), foreign investors (5.2%) and others (36.6%).

In the last twelve months ended December 31, 2014, Sanepar reported net sales of BRL 2.6 billion and net income of BRL 422 million.

Recent Events

On August 12, 2015, Moody´s affirmed Sanepar's issuer ratings at Ba1/Aa2.br. At the same time, Moody´s affirmed the ratings on BRL300 million in Brazilian debentures as well as the ratings on BRL 300 million in debentures at Ba1 and Aa2.br on the global and national scale, respectively. The outlook changed to negative from stable for all ratings.

On August 11, 2015, Moody´s downgraded Brazil's government bond rating to Baa3 from Baa2 and changed the outlook on the rating to stable from negative.

In June 2015, Sanepar issued a BRL300 million debenture in two tranches of BRL111 million and BRL189 million maturing in 2017 and 2018 respectively, of which Moody's rated as Ba1/Aa2.br with stable outlook.

On February 18, 2014, the State Government of Parana approved a 6.4% tariff increase, which has been in place since March 2014.

On October 23, 2013, Moody's America Latina Ltda (Moody's) assigned a Ba1 issuer rating on the global scale and Aa2.br issuer rating on the Brazilian national scale to Companhia de Saneamento do Paraná (SANEPAR). At the same time, Moody's assigned a Ba1 rating on the global scale and a Aa2.br rating on the Brazilian national scale to senior unsecured amortizing BRL 300 million debentures issued by Sanepar in two tranches with maturities in 5 and 7 years. The outlook was stable for all ratings.

On August 27, 2013, the company's two major shareholders, the State government of Parana and Domino, reached an agreement to settle an existing BRL 1.1 billion liability represented by advances for capital increase. As a result, the state government of Parana converted BRL 797 million into capital and received the remaining portion with the above debenture proceeds.

On June 11, 2013, Moody's withdrew Sanepar's Ba2/A1.br issuer ratings after existing rated debentures expired at the end of December 2012.

In February 2013, the State Government of Parana approved a 6.9% tariff increase, which has been in place since March 22, 2013.

On February 24, 2012, Moody's upgraded the ratings of the BRL55 million senior unsecured debentures due 2012 issued by Sanepar to Ba2 from Ba3 on global scale and to A1.br from A3.br on the Brazilian national scale. The review was prompted by the announcement of a 16.5% tariff increase on Sanepar's water and sewage services in February 2012. This was the second consecutive tariff adjustment approved by the state government in seven years. On February 2011, the state government approved rate relief of 16% breaking the cycle of a prolonged tariff freeze.

SUMMARY RATING RATIONALE

The Ba1/Aa2.br issuer ratings reflect Sanepar's strong credit metrics for the rating category along with its relatively predictable and stable cash flow supported by long-term contracts with most of the municipalities in the state of Parana to provide water and sewage services. The agreement between the company's two major shareholders on the previous BRL 1.1 billion in advances for capital increase further supports the ratings.

Sanepar's ratings are constrained by the early development stage of the regulatory framework for the two states where the company operates, its sizeable capital expenditure program and the track record of political interference by the state government of Parana which kept Sanepar's tariffs frozen from 2005 through 2010.

Sanepar is considered a Government Related Issuer (GRI) as defined in Moody's rating methodology entitled "The Application of Joint Default Analysis to Government-Related Issuers". Moody's methodology for GRIs is to systematically incorporate into the rating both the stand-alone credit risk profile or Baseline Credit Assessment (BCA) of the company as well as an assessment of the likelihood that its government owner would provide extraordinary support to the company's obligations when needed given in our opinion high dependence (i.e. the likelihood that Sanepar and the State of Parana would default at the same time), and a moderate level of government support from the controlling shareholder.

Please refer to Moody's "Government Related Issuers: Methodology Update", published in July 2010, available at moodys.com for additional information on GRIs.

In accordance with Moody's methodology for government related issuers, or GRIs, the Ba1 issuer rating of Sanepar reflects the combination of the following inputs:

-Baseline Credit Assessment (BCA) ba2

- High-level dependence

- Moderate level of government support

- The Baa3 rating of the State Government of Parana, which has a negative outlook.

The Aa2.br national scale issuer rating reflects the standing of credit quality relative to domestic peers. Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issuances and issuers within a country, enabling market participants to better differentiate relative risks. NSRs in Brazil are designated by the ".br" suffix. NSRs differ from global scale ratings in that they are not globally comparable to the full universe of Moody's rated entities, but only with other rated entities within the same country.

DETAILED RATING CONSIDERATIONS

ATTRACTIVE CONCESSION AREA

Sanepar benefits from its monopolistic rights to provide water and sewage services through long term public concessions in attractive areas that covers most of the territory of the Parana state in the South of Brazil. As measured by GDP, the state of Parana is the fifth largest state in Brazil with a large and diversified economic base with a GDP per capita above the country's average.

The utility has invested substantially in the expansion of its network and currently provides treated water to 100% and sewage collection to 64.5% of the urban population in its concession areas. The company aims at increasing sewage collection and treatment in the near future. Sanepar is regarded as an efficient water utility when compared to local peers, having managed to control costs and maintain productivity.

While only about 51% of the Brazilian urban population have access to sewage collection, of which just 35% is treated before disposal, Sanepar is treating about 99.5% of the collected sewage in its concession areas. Nevertheless, the company's overall efficiency indicators still compare quite unfavorably with international peers, particularly in regard to water losses of around 32% as of June 30, 2014.

SIGNIFICANT CAPEX PROGRAM

Sanepar has a planned BRL 2.5 billion capital expenditure program from 2014 through 2016 to reduce current water losses and increase its current 64.5% coverage of water and sewage services to the population in its concession area. Historically, the successful execution of Sanepar's investment program has just been made by securing adequate long-term funding.

The expansion programs have historically been funded by long-term debt, mostly granted by federal government owned financial entities such as Caixa Economica Federal (CEF) and Banco Nacional de Desenvolvimento Econômico e Social (BNDES), which typically provide loans at subsidized interest rates and favorable repayment conditions as compared with the prevailing conditions in the local bank and capital markets.

STRONG CREDIT METRICS BOOSTED BY MATERIAL TARIFF INCREASES OVER THE PAST FOUR

YEARS

Sanepar posted consistently weaker operating margins from 2005 to 2010 as a result of the tariff freeze imposed by the state government. From 2011 to 2014 the state government of Parana has granted material tariff increases to Sanepar of 16%, 16.5%, 6.9% and 6.4%, respectively.

As a result of these tariff adjustments, the company's FFO to Net Debt ratio improved to 30% in the last twelve months ended June 30, 2014, from 26% registered in 2010 while the interest coverage ratio improved to 6.9x from 5.4x in the same period. Sanepar's debt profile is considered adequate as long term debt maturities are comfortably covered by CFO after dividends.

The company's strong cash flow has largely stemmed from its relatively stable operating margins (an average of 29.9% over the last four years) along with low financial expenses over the same period. The receipt of timely tariff adjustments over the last four years along with continuous annual volume sales growth explain the company's relatively stable and strong operating margins registered during this period.

On October 17,2013, a capital increase of BRL 797 million was approved as part of the BRL 1.1 billion advances for capital increase recorded as a liability as of June 30, 2013, which reduced the company's leverage ratio as measured by Debt to Capitalization to 41.1% at June 30, 2014 from 44.5% at December 31, 2012.

For the period 2014 to 2016, we forecast that cash flow will reduce as measured by the average FFO to Net Debt ratio to 20.4% which is down significantly from the previous three-year average of 35.5% while the Interest coverage ratio will remain relatively strong at 4.3x in the same period which compares unfavorably with the previous three-year average of 8.1x. The main reason for these forecasted declines is the sizeable planned capital expenditure program forecasted for the next three years (an average of BRL848 million per year). It worth mentioning that in our forecast we have been more conservative in our assumptions than the company as we considered lower revenue growth, higher costs and SG&A and CAPEX 5% higher than the number indicated by Sanepar.

Notwithstanding the still strong credit metrics for the rating category, the company's cash flow will continue to depend on timely and adequate tariff increases and the securing of adequate long term funding to meet its sizeable planned capital expenditure program.

UNDERDEVELOPED REGULATORY FRAMEWORK

The Federal Law 11,445 as of January 2007, also known as the Basic Sanitation Law, and the Presidential Decree 7,217 as of June 2010, established nationwide guidelines for basic sanitation and technical cooperation between states and municipalities. These legislative initiatives created a consolidated framework that specifically addresses the planning, supervision and operations of sanitation services in Brazil. Nevertheless, water and sewer services remain subject to several laws at both state and municipal levels. At the municipal level, Sanepar operates pursuant to long-term concession agreements with 346 city governments, which are the concession authorities.

Although the Basic Sanitation Law includes some provisions for annual tariff adjustments, the rates are typically set by a state regulatory agency that may not be completely independent from political interference. In the State of Parana, the water and sewage services are regulated by the Water Institute of Parana, a regulatory entity associated with the state government. The Water Institute was created on October 13, 2009 under the framework of the Basic Sanitation Law with the objective of providing institutional and technical support to the implementation of instruments from the Water Resources State Politics and to regulate and monitor the basic sanitation services in the state. The Water Institute is responsible for the reviews of Sanepar's periodic rate cases and for the determination of an appropriate tariff readjustment, but the ultimate approval is, however, a decision of the state governor.

Water utilities require a well established regulatory framework to ensure stable and predictable level of income and cash flow to support their capital-intensive activities. We deem the quality of the regulatory framework in the state of Parana for the water and sewage services as incipient given the lack of a formal and independent regulatory agency and a formal determination of the company's regulatory asset base, which prevents the settlement of a technical mechanism to periodically adjust the company's tariffs.

POLITICAL INTERFERENCE

The State of Paraná, as Sanepar's major shareholder, has supported the company as evidenced by its steady capital contributions by means of advances for future equity increases along with only moderate dividend requirements in recent years. Conversely, the state government maintained a tariff freeze from 2005 through 2010, while the utility maintained a significant capital expenditure program.

In September 2013, the company's board of directors decided to convert part of the state government advances for future capital increases into short-term debt. This decision was, in our opinion, the result of a long judicial dispute between the State of Parana and the minority shareholder Dominó with respect to a Shareholders' Agreement to control Sanepar.

On August 27, 2013, a new shareholding agreement was signed and in October 2013 an agreement regarding the advances for future capital increases was reached. Out of the total amount of BRL 1.1 billion, BRL 797 million was converted into preferred shares. As a result, Sanepar's total capital increased to BRL 2,597 million from BRL 1,800 million. Going forward, we expect that the state government of Parana will continue to support of Sanepar's operations and comply with the new shareholders' agreement.

ASSET OWNERSHIP MODEL

The key water and sewerage assets of Sanepar are held under long-term concessions with entitlement to recover the value of residual assets at the end of the concession; however, concession termination procedures are still untested. In general, the majority of Sanepar's municipal concession contracts expire in the long term, with an average contract life between 20 and 30 years. Nevertheless, around 7.5% of Sanepar's 346 municipal concession agreements have expired and are currently under negotiation to be renewed. An additional 4.9% of the concessions mature from 2014 to 2020 while 87.6% have agreements that expire after 2020. While the municipalities lack sufficient financial resources to fund investments or to reimburse Sanepar for past investments themselves, the company continues to operate the assets of expired concessions.

Sanepar is currently negotiating the renewal of those agreements for an additional 30 years under the framework of the Basic Sanitation Law, which requires the completion of a 4-year Sanitation Plan for each municipality. In 2009, the Parana governor created the Water's Institute to work as a regulatory agency for sanitation services in the state pursuant to cooperation agreements with the municipalities. Over the last few years we have seen little progress on the renewal of expired concessions as a result of delays in the implementation of new regulatory requirements. Looking forward, management expects to complete the renewals of 62% of the matured concessions up to 2015 and the remaining 38% during the next few years. A successful renewal of a significant number of expired concessions under a more stable regulatory framework that includes timely tariff adjustments for cost recovery could trigger a more positive view for Sanepar's ratings.

Liquidity

We deem Sanepar's liquidity as adequate in light of its cash position of BRL116 million vis-a-vis short term debt of BRL 186 million as of June 30, 2014. Additionally, Sanepar has been fairly resilient with its capital expenditure program as it historically has just invested when it has had access to long-term financing with adequate tenor and cost so as to earn an adequate return on the investment. Currently, the company has approved BRL1.9 billion in long term financing with BNDES, Caixa, Funasa and others, an amount which is sufficient to finance about 75% of the planned capital expenditures up to 2016, which substantially mitigates any liquidity issue during these years. Additionally, on October 10, 2014, the company's management approved raising 1year BRL100 million commercial paper to support its working capital needs.

We expect that Sanepar will balance its capital expenditures and the payment of dividends in the face of any cash shortfall which may occur;. for example, if the company is not granted tariff increases as planned or some other unexpected event negatively affects cash generation.

As previously mentioned, we believe that Sanepar's liquidity position will remain adequate.

Corporate Governance

Sanepar's corporate governance practices have evolved significantly since it adopted a permanent and independent supervisory council and started to publish quarterly cash flow statements. Additionally, in 2013 the litigation between the State of Parana and the minority shareholder Domino reached an agreement, which culminated with the settlement of the existing BRL 1.1 billion advances for future capital increase.

Sanepar's Board of Directors has nine members, of which five are appointed by the State of Parana. Three are nominated by minority shareholders and one by the employees.

Sanepar's By-laws limit the level of indebtedness in accordance to the following ratios:

- Net Debt / EBITDA equal to or lower than 3.0 times;

- EBITDA / Net Revenues equal to or higher than 35%;

- EBITDA / Debt Service equal to or higher than 1.5 times;

Sanepar has historically complied with its financial covenants.

Rating Outlook

The outlook could be stabilized if the sub-sovereign's credit quality improves significantly along with the company's financial performance improves consistently above our expectations. We also consider that Sanepar will manage its capital structure prudently and finance its Capex program and the payment of dividends in a way that keeps the company's credit metrics compatible with the rating category.

What Could Change the Rating - Up

There could be a rating upgrade if Sanepar strengthens its credit metrics on a sustainable basis as a result of stronger cash flow generation and lower leverage which would result if FFO to Net Debt rises above 25% and interest coverage increases above 4.5x on a sustainable basis. An upgrade will also depend on the maintenance of annual tariff adjustments and capital expenditure discipline. A rating upgrade could also be triggered by a perceived material evolution in the regulatory framework.

What Could Change the Rating - Down

We would consider a downgrade rating action if the company fails in securing adequate long-term funding to finance its BRL 2.7 billion current capital expenditure program for 2015 - 2017 period leading to a deterioration in its liquidity position. A potential new tariff freeze could also prompt a downgrade rating action that subsequently resulted in the FFO to Net Debt ratio falling below 15% and interest coverage declining to 3.5x or lower for an extended period. In addition, a further deterioration in the state of Parana's sub-sovereign or in the Brazil's sovereign credit quality could also trigger a rating action as well as our perception of a decline in the level of supportiveness, consistency and predictability of the state of Paraná and of Brazilian regulatory environment. The withdrawal of the rating of the State of Parana could also prompt a potential downgrade on Sanepar's ratings.

Rating Factors

Companhia de Saneamento do Paraná - SANEPAR

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current LTM 6/30/2014**			[3]**Moody's 12-18 Month Forward View**	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)	**Measure**	**Score**		**Measure**	**Score**
a) Stability and Predictability of Regulatory Regime	B	B		B	B
b) Asset Ownership Model	Ba	Ba		Ba	Ba
c) Cost and Investment Recovery (Ability & Timeliness)	B	B		B	B
d) Revenue Risk	Ba	Ba		Ba	Ba
Factor 2: Operational Characteristics & Asset Risk (10%)					
a) Operational Efficiency	Baa	Baa		Baa	Baa
b) Scale & Complexity of Capital Programme & Asset Condition Risk	Ba	Ba		Ba	Ba
Factor 3: Stability of Business Model & Financial Structure (10%)					
a) Ability & Willingness to Pursue Opportunistic Corporate Activity	Baa	Baa		Baa	Baa
b) Ability & Willingness to Increase Leverage	Baa	Baa		Baa	Baa
c) Targeted Proportion of Revenues Outside Core Water and Wastewater Activities	Aa	Aa		Aa	Aa
Factor 4: Key Credit Metrics (40%)					

a) FFO Interest Coverage (3 Year Avg)	7.83X	Aa	4.28X	Baa
b) Debt / Capitalisation (3 Year Avg)	49.4%	A	44.9%	A
c) FFO / Net Debt (3 Year Avg)	25.9%	Aa	20.4%	A
d) RCF / Capex (3 Year Avg)	0.91X	Ba	0.58X	Ba
Rating:				
Grid-Indicated Rating Before Notching Adjustment		ba2		ba2
HoldCo Structural Subordination Notching			0	0
a) Indicated Rating from Grid		ba2		ba2
b) Actual Rating Assigned		Ba1		Ba1

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	ba2
b) Government Local Currency Rating	Baa3
c) Default Dependence	High
d) Support	Moderate
e) Final Rating Outcome	Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 6/30/2014(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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