FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms CESP's Ratings

Feedback

Mon 19 Jul, 2021 - 5:15 PM ET

Fitch Ratings - São Paulo - 19 Jul 2021: Fitch Ratings has affirmed Companhia Energetica de Sao Paulo's (CESP) Long-Term (LT) Foreign Currency (FC) and Local Currency (LC) Issuer Default Ratings (IDRs) at 'BB' and 'BB+', respectively. Fitch has also affirmed the LT National Scale Rating at 'AAA(bra)' for CESP and its senior unsecured debentures issuance. The Outlook for the LT FC IDR is Negative, while the Outlook for both the LT LC IDR and the National Scale Rating is Stable.

CESP's LT LC IDR and National Scale Rating reflect its moderate to strong business profile within the power generation segment in Brazil, despite its asset concentration. The company should remain with a conservative capital structure, strong liquidity position and lengthened debt maturity schedule even considering challenging hydrological conditions in 2021 and 2022. CESP's LT FC IDR is constrained by Brazil's Country Ceiling of 'BB' and its Negative Outlook follows Brazil's 'BB-'/Negative sovereign rating.

KEY RATING DRIVERS

Robustness to Cope with Water Crisis: CESP has a strong balance sheet to absorb the effects from worsening hydrological conditions in Brazil, despite being more affected than its average peers. CESP depends solely on hydro generation and carries energy deficits inherited from a previous administration. Assuming a 0.75 average generation scaling factor (GSF) in 2021 and 0.80 in 2022, purchases are estimated at 375 aMW and 160 aMW, respectively, including 74 aMW in the spot market in 2022.

Average purchase prices are estimated at BRL235/MWh and BRL209/MWh, resulting in a total cost of BRL1.0 billion in 2021-2022. These figures, which do not include the trading business, imply a BRL630 million loss compared with previous estimates, when GSF was assumed to be flat at 0.84. Lower assumptions for GSF will likely decrease EBITDA to BRL842 million in 2021 and BRL1.0 billion in 2022, from BRL1.2 billion in 2020.

Leverage Remains Conservative: Effects from both the worsening hydrological environment and revised contingent cash flows are manageable due to CESP's historical low leverage and high financial flexibility. The company should present total debt/EBITDA and net debt/EBITDA below 2.5x and 2.0x, respectively, during the rating horizon, with gross leverage at 2.2x and net leverage at 1.8x in 2021. The company ended 1Q21 with total debt of BRL1.8 billion, comprised of two debentures issuances averaging a seven-year term, with a comfortable amortization schedule.

Pre-Dividends FCF Still Strong: CESP's cash flow from operations (CFFO) should remain robust even considering the worsening in the hydrological scenario, with some reduction compensated with lower dividends distributions. The base case for the rating considers CFFO of BRL460 million in 2021 and negative BRL252 million in 2022, in case a single tax payment of BRL630 million occurs.

As the capex for CESP is very low, dividends determine the company's FCF. Fitch forecasts average negative FCF of BRL633 million in 2021-2022, considering total dividend payments of BRL1.45 billion in the same period. Compared with previous estimates, pre-dividend FCF is expected to decline to BRL1.3 billion in 2021-2022, while dividends fall by BRL1.8 billion, reflecting the company's flexibility.

High Quality Sales Portfolio: Sales to energy generation and distribution companies present low counterparty risk and account for around 60% and 20%, respectively, of total contracted sales to be settled until 2024. This compensates for some concentration that might exist in some clients in the free market. The growth of the trading business will facilitate client diversification but is expected to generate negative margins of BRL33 million in 2021 and BRL14 million in 2022.

Sales volumes should reach 1.1 aGW in 2021 and 917 aMW in 2022 at average prices of BRL236/MWh and BRL252/MWh, respectively. The base case scenario considers declining prices as of 2023 for both existing and new contracts to be negotiated in the free market, with sales to the regulated market adjusted by inflation.

Asset Concentration: CESP compares negatively with peers in terms of asset base and diversification. HPP Porto Primavera accounts for 95% of the company's total assured energy (935aMW) and is expected to become the company's single asset by May 2022. This is after termination of HPP Paraibuna's concession, assuming the company will accept an estimated 15-month extension based on Law 14.052/20, for which there will not be cash disbursement. Despite higher risks associated to asset concentration, management's strategy in focusing on derisking prior to expansion is credit-positive.

Negative Developments on Contingencies: Fitch revised estimates of cash inflows arising from the legal dispute concerning HPP Tres Irmaos' indemnification. The new base case assumes a first installment in 2023, rather than 2021, from BRL3.5 billion to be received until 2030, SELIC-adjusted. It also adds annual payments of BRL70 million, as of 2022, to settle the BRL888 million actuarial deficit that emerged mostly in 2020, due to inflation adjustment.

Litigations of BRL1.6 billion as of March 2021 will likely consume around BRL300 million every year in cash settlements. Off-balance litigations of BRL8.9 billion, of which, 66% relate to claims with remote loss probability, as deemed by CESP, will continue to pose a tail risk in the near future. However, the cash effect from unexpected losses would likely be diluted over several years.

DERIVATION SUMMARY

CESP's LT LC IDR is one notch below the LT LC IDR of Engie Brasil Energia S.A.'s (Engie BR; BBB-/Negative). Compared to CESP, Engie BR benefits from a larger scale and more diversified asset base in the power sector. Engie BR is also better positioned to face the current water crisis in Brazil, with lower estimated financial effects. Projections for Engie BR's net leverage are close to CESP's for 2021-2022, although the former is expanding into transmission lines and wind farms.

Compared with Transmissora Aliança de Energia Eletrica S.A. (Taesa, LC IDR BBB-/Negative), the transmission segment presents lower business risk, with higher revenue predictability and stronger margins. Taesa also benefits from a diversified assets portfolio, low leverage and robust liquidity profile.

KEY ASSUMPTIONS

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

-- GSF: 0.75 in 2021, 0.80 in 2022, 0.85 in 2023 and 0.93 in 2024;

-- Sales volume (aMW): 1,113 in 2021, 917 in 2022 and average 807 in 2022-2023;

-- Weighted average sales price (BRL/MWh): 235 in 2021, 209 in 2022 and average 167 in 2022-2023;

-- Purchase volume (aMW): 375 in 2021, 160 in 2022 and average 11 in 2023-2024;

-- Weighted average purchase price (BRL/MWh): 236 in 2021, 252 in 2022 and average 219 in 2022-2023;

-- Dividends (BRL Mi.): 850 in 2021, 600 in 2022 and a total 1,500 in 2023-2024;

-- Indemnification from HPP Tres Irmaos: BRL1.0 billion cash inflow in 2023-2024;

-- Litigations: annual cash disbursements of BRL300 million.

RATING SENSITIVITIES

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

--The Outlook for CESP's LT FC IDR would be revised to Stable with the same movement for the Sovereign Outlook;

-- Diversification of the asset base;

-- Total debt/EBITDA and net debt/EBITDA remaining at the current levels, limited to 3.0x and 2.5x, respectively;

-- Maintenance of a strong liquidity profile.

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

-- A sovereign downgrade would trigger a downgrade on the company's LT FC IDR;

-- Total debt/EBITDA and net debt/EBITDA above 4.0x and 3.5x, respectively;

-- Strong operational issue related to performance at Porto Primavera HPP;

-- Deterioration in the liquidity profile;

-- Unfavorable developments on contingent liabilities that could materially affect the company's liquidity in the rating horizon.

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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: CESP should maintain conservative liquidity levels in the coming years, despite the expected negative FCFs until 2022. Cash balance was BRL870 million at the end of March 2021, with short-term debt of BR5 million related to debentures' interest. Annual debt amortization will not exceed BRL75 million until 2025. The company also counts on access to diversified sources of funding.

ISSUER PROFILE

Companhia Energetica de Sao Paulo (CESP) is a publicly-traded company that operates Porto Primavera, a 1.5 GW hydro power plant (HPP) located in Brazil's Southeast region. CESP is controlled by VTRM Energia e Participacoes S.A. (VTRM), a 50/50 joint venture between Votorantim Geracao de Energia S.A. and the Canadian fund CPPIB. VTRM owns

40% of CESP's total shares and 93.5% of the voting shares, with the remaining held as free float. The company was privatized in 2018 and is listed at the Brazilian stock exchange B3. More than 80% of CESP's revenue forecast until 2024 is guaranteed by long-term, inflation-adjusted power purchase agreements (PPAs).

SUMMARY OF FINANCIAL ADJUSTMENTS

The following expenses were added back to EBITDA: 1) Provisions for litigations; 2) Impairments on fixed assets; 3) Provisions or reversions related to contingent assets or liabilities; 4) Extraordinary SG&A costs related to voluntary dismissal plan; 5) Losses on currency derivatives; 6) Marking-to-market of energy contracts; 7) Write-off of judicial deposits.

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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
CESP - Companhia Energetica de Sao Paulo	LT IDR	BB Rating Outlook Negative	Affirmed	BB Rating Outlook Negative

ENTITY/DEBT	RATING			PRIOR
	LC LT IDR	BB+ Rating Outlook Stable	Affirmed	BB+ Rating Outlook Stable
	Natl LT	AAA(bra) Rating Outlook Stable	Affirmed	AAA(bra) Rating Outlook Stable
• senior unsecured	Natl LT	AAA(bra)	Affirmed	AAA(bra)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 30 Apr 2021)

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

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

CESP - Companhia Energetica de Sao Paulo	EU Endorsed, UK Endorsed

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