Research Update:

Brazilian Power Co CESP's 'BB-' Ratings Affirmed, Stand-Alone Credit Profile Revised To 'bb+' On Wider Pension Deficit

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Rating Action Overview

- Brazil-based hydropower generator CESP-Companhia Energetica de Sao Paulo has been posting sound cash flows and comfortable liquidity, despite drier conditions, thanks to solid power contracts' allocation strategy and cost-control initiatives.
- S&P Global Ratings affirmed its 'BB-' global scale and 'brAAA' national scale credit ratings on CESP.
- We also revised our stand-alone credit profile (SACP) of CESP to 'bb+' from 'bbb-', incorporating a wider pension plan deficit in the first quarter of 2021 because of high inflation measured by IGP-M and historically low interest rates in Brazil.
- The stable outlook on CESP reflects that on Brazil, given the sovereign rating cap on the company's credit quality.

Rating Action Rationale

The company has been resilient to the pandemic-related downturn. Despite lower demand for energy, CESP's operations remained solid because it sells energy through long-tenor, take-or-pay contracts with creditworthy counterparties in the regulated and free markets. In the 12 months ended March 31, 2021, the company reported a 20% increase in revenue despite drier conditions, thanks to the start of its trading division operations, higher sales volume in the free market, and contractual readjustments linked to inflation. We believe CESP will continue generating strong funds from operations (FFO) of R$700 million – R$750 million in the next couple of years to service its debt and cover limited maintenance capital expenditures (capex), while it maintains high dividend payouts.

The SACP revision reflects higher adjusted debt because of the widening pension plan deficit. Historically low interest rates in Brazil over the past few years dented the present value of the company's pension plan and the expected return on plan assets. Moreover, high inflation measured by IGP-M, which increased over 23% in 2020, remunerates part of the liabilities of CESP's defined benefit category plan, which we adjust the net amount as debt. The company reported a R$2.45 billion deficit in the first quarter of 2021, following IFRS standards, up from R$837 million in the fiscal 2019. CESP is working on mitigating actions in order to narrow the deficit by offering beneficiaries the option of migrating from defined benefit to defined contribution category, given that in the latter plan, the company doesn't have legal obligations in case of actuarial deficits. The migration depends on approval from Brazil's National Complementary Welfare Superintendence (PREVIC) and the beneficiaries' acceptance. Our base-case scenario assumes a 15% adoption by the end of 2021. As a result, we now expect debt to EBITDA in the high 3x area and FFO to debt of about 20% this year.

Commercial strategy to reduce hydrological risk. Throughout 2020 and in the first quarter of 2021, CESP purchased close to 95% of its energy requirements in 2021. We believe this is positive given the lower generation scaling factor (GSF) of 78% for this year, according to Câmara de Comercialização de Energia Elétrica (CCEE). In our view, this strategy limits exposure to potentially volatile spot prices, increasing predictability of the company's cash flows. Therefore, we expect CESP to maintain EBITDA margins at 50%-55%, compared with 52.9% in 2020, also thanks to cost-control initiatives, including the voluntary dismissal program completed in 2019.

Judicial disputes are still ongoing. CESP is involved in litigations related to environmental and land disputes where its hydro plants are located, totaling approximately R$10.2 billion in contingent liabilities in April 2021, R$1.6 billion of which the company reports as likely. The company is focusing on reaching agreements to reduce the amount of such liabilities by creating a task force and hiring external counsel. Despite the sizable number of disputes, we don't expect a hit to the company's leverage or liquidity. This is because CESP not only has provisions for these claims, but also benefits from funds in escrow accounts to back such claims. In addition, CESP is suing the federal government over the indemnity of non-amortized investments in the company's previous concession, Três Irmãos, which wasn't renewed under the Law 12,783/2013, in which the company claims the uncontested amount of at least R$1.7 billion. The litigation is still open following the April 27, 2021, rejection of CESP's appeal for the immediate receipt of the amount.

Outlook

The stable outlook on CESP reflects that on the sovereign, given our view that ratings on the latter limit those on the company. This is because of CESP's sensitivity to the domestic economy and because all of its assets and counterparties are located in the country. Consequently, the 'bb+' SACP, two notches above the issuer credit rating, provides a protection.

Downside scenario

Given that we cap the ratings on CESP at the sovereign level, if we were to downgrade Brazil in the next 12 months, we could take a similar rating action on the company. We don't envision a scenario in the near term that could lead us to revise downward again the SACP. However, we could downgrade CESP if it pursues a more aggressive financial policy, leading to net debt to EBITDA consistently above 4.5x.

Upside scenario

We don't expect an upgrade in the next 12 months, because the sovereign rating cap. Although we currently view an upward SACP revision as unlikely, we could do so if the company's adjusted debt drops, leading to debt to EBITDA below 2.0x on a consistent basis. That could happen as a result of much narrower-than-expected pension fund deficits.

Company Description

CESP is a Brazil-based electric power generation company that holds the concession of two hydroelectric power plants that operate under concession agreements, Porto Primavera with 1,540 megawatts (MW) of capacity until April 2049, and Paraibuna with 48 MW of installed capacity until September 2021.

Our Base-Case Scenario

- Inflation, which we link to power contract readjustments and general and administrative expenses, of 5.1% in 2021 and 3.9% in 2022.
- A GSF, which determines the company's level of energy delivery, of 78% in 2021 and improving to 82% in 2022, assuming more favorable hydrology conditions.
- Power acquired from third parties (the bulk of which are under short-term contracts made in advance) totaling 300 MW -350 MW in 2021, the majority of which is already set, and 150 MW - 200 MW in 2022.
- Annual maintenance capex of about R$20 million.
- Working capital requirements of about R$350 million in 2021 and R$250 million in 2022, half of which we assume will be used for covering contingent liabilities.
- No acquisitions or major investments.
- Dividends distribution of R$850 million, including interest on equity, in 2021, according to the company. Afterwards, we assume at least a 50% dividend payout of previous year's net income.
- Starting in 2021, we adjust 85% of the pension plan's deficit position, assuming the company will be able to migrate part of the current defined benefit plan beneficiaries to the defined contribution type.

Based on these assumptions, we expect CESP to post the following credit metrics in 2021 and 2022:

- Adjusted EBITDA margins of 50%-55% in 2021 and improving to 55%-60% in 2022;
- Net debt to EBITDA in the high 3x area in 2021 and in the low 3x area in 2022;
- FFO to debt of about 20% in 2021 and in the mid-20% range in 2022; and
- EBITDA cash interest around 6.0x.

Liquidity

In our view, CESP's liquidity remains adequate. We expect cash sources to exceed uses by more than 20% in the upcoming 12 months, and the difference between sources and uses to remain positive in the same period, even if EBITDA were to be 15% lower than in our base-case scenario. We believe CESP will continue generating sound cash flows to service its debt, and cover maintenance capex and working capital requirements, while remunerating shareholders with dividends.

Principal Liquidity Sources

- Cash position of R$870 million as of March 31, 2021; and
- Expected operating cash flows after interest and taxes of about R$680 million in the next 12 months.

Principal Liquidity Uses

- Short-term debt of R$5.4 million as of March 31, 2021;
- Working capital outflows of up to R$300 million in the next 12 months;
- Annual maintenance investments of about R$20 million in the next 24 months; and
- Dividend and interest on equity payment of R$850 million in 2021, as CESP recently announced.

Covenants

CESP is not subject to financial covenants.

Environmental, Social, And Governance

Environmental and social aspects are relevant to our analysis on CESP. Porto Primavera is a hydroelectric plant with a large reservoir, which is surrounded by the riparian forest, which requires preservation efforts in order to avoid erosion and other impacts to the company's operations, and to meet the safety standards as required by the regulator. Also, CESP is a party to legal proceedings related to environmental and land disputes of the hydro dams in its portfolio. While management is focusing on reaching agreements to reduce the amount of contingent liabilities, we don't expect its leverage or liquidity to suffer because CESP has set aside provisions for these claims and benefits from funds held in escrow accounts to back such claims.

Ratings Score Snapshot

Issuer Credit Rating:

- Global scale: BB-/Stable/--
- National scale: brAAA/Stable/--

Business Risk Profile: Fair

- Country Risk: Moderately high

- Industry Risk: Moderately high
- Competitive Position: Fair

Financial Risk Profile: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

SACP: bb+

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed

CESP-Companhia Energetica de Sao Paulo	
Issuer Credit Rating	BB-/Stable/--
Brazil National Scale	brAAA/Stable/--

	To	From
CESP-Companhia Energetica de Sao Paulo		
Analytical Factors		
Local Currency	bb+	bbb-