FitchRatings

RATING ACTION COMMENTARY

# Fitch Assigns First-Time 'BB' IDR to CESP; Outlook Negative

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Fitch Ratings - São Paulo - 29 Jul 2020: Fitch Ratings - Rio de Janeiro - 29 July 2020: Fitch Ratings has assigned first-time Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) of 'BB' and 'BB+', respectively, and National Scale rating of 'AAA(bra)' to CESP - Companhia Energetica de Sao Paulo. The Rating Outlook for the Foreign-Currency IDR is Negative, while the Rating Outlook for the Local-Currency IDR and National Scale rating is Stable.

CESP's IDRs reflect its moderate to strong business profile within the power-generation segment in Brazil, combined with a conservative capital structure, strong liquidity position and lengthened debt maturity schedule. Cash generation is highly concentrated in a single asset, as 95% of its current 1,627MW of installed capacity comes from Hydroelectric Power Plant (HPP) Porto Primavera, which limits the ratings. Positively, Fitch expects the company to realize strong pre-dividend free cash flow (FCF), reflecting robust operational cash generation from medium- to long-term sales contracts with favorable prices and the absence of relevant investments in the coming years. A high volume of dividends should result in negative FCFs until 2022.

The ratings also incorporate the moderate diversification and high quality of CESP's client base in terms of energy sold. Sales to power distribution companies on the

Regulated Contracting Environment (ACR) is not a concern and Fitch believes that the sales portfolio at the Free Contracting Environment (ACL) market will be resilient against the impacts from Covid-19 on volumes and delinquency. CESP's ratings reflect some degree of uncertainty regarding the estimated amounts related to litigation liabilities, as well as the risks of managing a short energy balance during the current stressed hydrological conditions.

The Negative Rating Outlook for CESP's Foreign-Currency IDR considers the Negative Rating Outlook for Brazil's sovereign rating (BB-). Since the company receives all its revenues in Brazilian reals, with no cash or committed credit lines abroad, Fitch does not see its Foreign-Currency IDR above the Country Ceiling (BB). In the event of a sovereign downgrade, the Country Ceiling will likely be reduced and, as a consequence, CESP's Foreign-Currency IDR as well. The analysis does not include the possibility of support by controlling shareholders.

The Stable Rating Outlook of both the Local-Currency IDR and the National Scale rating reflects the expectation that CESP will maintain its solid cash-generation capacity and preserve strong liquidity and conservative credit metrics, with net debt/EBITDA limited to 2.5x.

## KEY RATING DRIVERS

Positive Performance: CESP should continue improving its EBITDA generation and margin in the next couple of years, based on higher energy sales volumes and average prices, along with a more efficient cost structure. Fitch forecasts net revenues of BRL2.0 billion in 2020 and 2021, with EBITDA of BRL1.0 billion and a 50% EBITDA margin in 2020, increasing to BRL1.2 billion and 59%, respectively, in 2021. Those figures favorably compare with net revenues of BRL1.6 billion, EBITDA of BRL752 million and EBITDA margin of 48% in 2019. The base case scenario considers energy sales volumes of 1,167MWa in 2020 and 1,072MWa in 2021, and a weighted average sales price of BRL216/MWh and BRL243/MWh, respectively. In 2019, sales volume totaled 993MWa and the weighted average price was BRL202/MWh. The expansion of the trading business through CESP Comercializadora's activities, which started in early 2020, should continue to have a limited contribution to cash generation.

Low Asset Diversification Limits Ratings: CESP's ratings incorporate the risks associated with high concentration in its asset base. Currently, HPP Porto Primavera accounts for 95% of the total assured energy of the company (935MWa), already excluding HPP Jaguari, whose concession was ended in May 2020 and is operated by CESP on a temporary basis until a new bid occurs. HPP Paraibuna concession, in turn, ends in March 2021. Therefore, Fitch's base case assumes that, as of April 2021, Porto Primavera will be CESP's single asset.

Moderate Client Base Diversification: CESP has a moderate diversified client base. Sales in the regulated market were negotiated with 32 distributors, with negligible counterparty risk, but more than 90% of sales volume in the ACL market is concentrated in six clients. Under Fitch's projections, around 25% of energy sales in the 2020-2023 period will be traded in the regulated market and 75% in the ACL market. Contracts negotiated in the ACL market have a remaining weighted average term of 3.1 years, while contracts sold in the ACR market will be effective until 2038 and 2039.

Strong Pre-Dividend FCF Is Positive: Fitch expects CESP to present strong pre-dividend FCF due to robust cash flow from operations (CFFO) and low capex levels. High dividend payments should result in negative FCFs until 2022, but the company has flexibility to reduce them, if needed, to limit leverage metrics. The base case scenario for 2020 considers a CFFO of BRL377 million, with negative FCF of BRL242 million after capex of BRL13 million and dividends of BRL606 million. Fitch's projections for the 2020-2023 period include total capex of around BRL50 million and total dividends of around BRL4.0 billion, corresponding to dividend payout ratios higher than 100%.

Conservative Leverage to Remain: Fitch believes that CESP will maintain conservative leverage metrics with total debt/EBITDA and net debt/EBITDA ratios limited to 3.0x and 2.5x, respectively, in the coming years. In the base case scenario for 2020, these ratios will be 1.8x and 1.3x, respectively. In the last 12 months ended March 31, 2020, total debt/EBITDA was 1.6x and net debt/EBITDA, 0.7x. The company ended the first quarter of 2020 with total debt of BRL1.8 billion, related to debentures issued in January 2019 to pay the BRL1.4 billion grant for the early renewal of HPP Porto Primavera's concession, in the context of CESP`s privatization.

Manageable Potencial Contingencies: Fitch considers CESP's contingencies as manageable. The company maintains on its balance sheet relevant provisions, related to old litigations, totaling BRL1.9 billion. The base case scenario incorporates cash disbursements of BRL1.2 billion over the projection horizon (2020 to 2023) and payments materially above this amount are unlikely. On the other hand, CESP expects to receive BRL1.5 billion in the same period (out of a total BRL1.7 billion until 2024), referring to the indemnification of assets related to HPP Três Irmãos, which were reverted to the federal government in the past, but not fully amortized. Fitch's projections assume a first cash inflow of BRL428 million to occur in 2021, with subsequent annual installments thereafter.

Hydrological Risk Not Impacting the IDR: CESP's exposure to hydrological risk is moderate. Based on the projected energy spot price (PLD), Fitch estimates an impact of BRL13 million on 2020 net revenue in the ACL market for each lower centesimal point in the Generation Scaling Factor (GSF). In the base case scenario, the agency considered an average GSF of 0.84 over the entire projected period. Contracts sold in the regulated market are fully protected against hydrological risk due to the renegotiation carried out in 2016, pursuant to Law 13,203/15, which eliminated the hydrological risk, upon payment of an annual premium.

Resilient Client Base to Coronavirus Effects: CESP's credit profile should not be materially affected during the Covid-19 pandemic. Fitch does not foresee any issue in sales on the ACR market and believes that the customer portfolio in the ACL market is resilient to the current pandemic effects, considering the large size and economic sectors of the main clients (energy and mining sectors account for 72% of future contracted demand). Most of the existing contracts in the ACL market do not provide flexibility in energy consumption. Any flexibilities, when applicable, are limited to 5% of the energy contracted on an annual basis, and are incorporated in the projections of the rating case scenario. Losses from flexibility are estimated at BRL13 million in 2020. Fitch believes that, until the current data, few contracts had been subject to renegotiation and, in such cases, the company has been successful in providing non-costly deferrals. In addition, CESP has benefited from the short position of the energy balance, as it has being able to reduce the 2020 deficit at exceptionally low prices.

## DERIVATION SUMMARY

CESP's Foreign-Currency IDR is two notches below the Foreign-Currency IDR of AES Gener S.A. (AES Gener; BBB-/Stable). This difference is reduced to one notch when comparing the Local-Currency IDRs of both companies. Relative to Engie Brasil S.A. (Engie Brasil; BBB-/Negative), CESP's Local-Currency IDR is one notch lower. Engie Brasil's Foreign-Currency IDR of 'BB'/Negative is also constrained by Brazil's Country Ceiling of 'BB'.

In terms of the Local-Currency IDR, AES Gener and Engie Brasil benefit from a more diversified asset base in the power sector than CESP. Engie Brasil also presents larger scale and a conservative financial profile, with net leverage below 2.0x, despite significant capex disbursements for its transmission lines under construction and wind power projects. AES Gener benefits from its operations in investment countries, as most of its revenues are originated in Chile and Colombia. According to Fitch's projections, AES Gener's leverage, as measured by net debt/EBITDA, is expected to remain at around 4.0x until 2021, pressured by the construction of Alto Maipo HPP.

Considering the National Scale rating, CESP's 'AA+(bra)' is the same as that of AES Tiete Energia S.A. (AES Tiete) and Eneva S.A. Although AES Tiete benefits from a diversified base of the generation segment and larger scale (3.3GW in installed capacity), distributed between nine HPPs and three small hydroelectric plants, with a remaining weighted average term of around nine years, Fitch projects more stretched net leverage ratios for Tiete, between 3.0x and 3.5x, by 2022.

Eneva is the third largest thermal generator in Brazil with 2.2GW of installed capacity allocated to six operating plants. The company secures its own supply of natural gas, which fuels 66% of its current capacity. The remaining capacity operates with coal acquired from third parties. Compared to CESP, Eneva operates at higher levels of financial leverage, especially due to the need of continuous investments in hydrocarbon exploration and production. Fitch estimates Eneva's total adjusted net debt/EBITDA ratio at 2.9x in 2020 and 2.3x in 2021. Both companies have a demonstrated track record of operating efficiency.

## KEY ASSUMPTIONS

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

--Non-renewal of the Jaguari HPP concession maturing in March 2021.

--Sales volume of 10.3TWh in 2020, 9.4TWh in 2021 and average of 7.2TWh between 2022 and 2023, in the generation business.

--Average sales price of BRL216/MWh in 2020, BRL242/MWh in 2021 and BRL243/MWh between 2022 and 2023, in the generation business.

--Average PLD price of BRL77/MWh in 2020, BRL118/MWh in 2021 and BRL127/MWh between 2022 and 2023.

--GSF flat at 0.84.

--Capex disbursement of around BRL50 million in the 2020-2023 period.

--Dividends of around BRL4.0 billion in the 2020-2023 period, and BRL606 million in 2020.

--Payments of BRL1.2 billion related to litigation in the 2020-2023 period.

## RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action: --The Outlook for CESP's Foreign-Currency IDR will be revised to Stable from Negative in case of the same movement for the Outlook of the sovereign rating (BB-). --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. Developments that May, Individually or Collectively, Lead to Negative Rating Action: --A downgrade on the sovereign rating will likely trigger a downgrade on the company's Foreign-Currency IDR. --Total debt/EBITDA and net debt/EBITDA above 4.0x and 3.5x, respectively. --Strong operational issue related to the performance of Porto Primavera HPP. --Deterioration in the liquidity profile.

## 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: Fitch believes that CESP will maintain conservative liquidity levels in the coming years, despite the expected negative FCFs until 2022. The company's credit profile benefits from a high cash balance and lengthened debt maturity schedule. Due in 2025, the first amortization of the 11th issuance of debentures - the company's sole debt with an outstanding amount of BRL1.8 billion as of March 31, 2020 - will occur only in 2022, in the amount of BRL446 million. The cash balance at the end of the first quarter was BRL950 million, with short-term debt of BR25 million related to debenture interest. Debentures are guaranteed by receivables from CESP.

## DATE OF RELEVANT COMMITTEE

22 July 2020

## 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.

## RATING ACTIONS

| ENTITY/DEBT | RATING | | |
|---|---|---|---|
| CESP - Companhia Energetica de Sao Paulo | LT IDR | BB Rating Outlook Negative | New Rating |
| | LC LT IDR | BB+ Rating Outlook Stable | New Rating |

| ENTITY/DEBT | RATING | | |
|---|---|---|---|
| | Natl LT | AAA(bra) Rating Outlook Stable | New Rating |

VIEW ADDITIONAL RATING DETAILS

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## APPLICABLE CRITERIA

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

Metodologia de Ratings Corporativos (pub. 08 May 2020)

National Scale Rating Criteria (pub. 08 Jun 2020)

Metodologia de Ratings em Escala Nacional (pub. 08 Jun 2020)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 26 Jun 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

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
| CESP - Companhia Energetica de Sao Paulo | - |

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