Research Update:

Companhia Energetica de Sao Paulo 'BB' And 'brAAA' Ratings Affirmed And Off Watch On Parent's Expected Deleveraging

November 22, 2024

Rating Action Overview

- Although the recent acquisition of AES Brasil will pressure Auren Energia's financial indicators in 2025 and 2026, followed by the deleveraging, we expect Auren to benefit from a larger scale, diversification of assets, and predictable cash generation given that the acquired assets come with a long-term contractual profile.
- Although the acquisition won't impact CESP-Companhia Energetica de Sao Paulo (CESP) directly, we will continue assessing it as a core subsidiary of Auren, as pro forma the acquisition, CESP will account for at least 15% of the group's cash flow, given its long-term remaining concession, and because Auren manages its subsidiaries in an integrated manner. In this sense, the rating on CESP would move in tandem with Auren's creditworthiness.
- In this context, on Nov. 22, 2024, S&P Global Ratings affirmed its global scale 'BB' and national scale 'brAAA' ratings on CESP and removed them from CreditWatch with negative implications, where were placed them on May 30, 2024.
- The outlook is now stable, reflecting our view that the Auren's focus is now on absorbing and improving the operational efficiency of the acquired assets, while reducing selling, general, and administrative (SG&A) costs. We expect Auren's debt to EBITDA of 5.0x-5.5x and funds from operations (FFO) to debt of 7%-10% in 2025 and 2026, but approaching 4.5x and 12%, respectively, in 2027.

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Rating Action Rationale

The rating affirmation on CESP is based on our expectation that Auren will reduce leverage in the near term. Despite higher leverage due to the group's recent acquisition, we expect Auren to generate positive free cash flow starting in 2025. Auren expects to increase the operating efficiency of the portfolio of assets acquired and streamline its SG&A expenses, resulting in operational gains that could accelerate its deleveraging pace. We also expect Auren to conduct liability management aiming at extending its debt maturity profile and overall debt service costs. We will monitor Auren's ability to capture the planned efficiency gains, which would be key to reducing its leverage. We project debt to EBITDA of 5.0x-5.5x and FFO to debt of 7%-10% in 2025 in 2026, improving to 4.5x and 12%, respectively, in 2027.

We do not expect Auren to experience liquidity pressures for the next 12 months, as it financed the R$6.36 billion acquisition primarily with the proceeds of its four-year R$5.4 billion fourth debentures issuance and cash position, which was at R$7.4 billion at Sept. 30, 2024.

Greater scale and cash generation diversification are favorable for Auren's business. The acquisition, completed on Oct. 31, 2024, more than doubled Auren's generation capacity, (AES Brasil's 5.2 gigawatts [GW]). The group now has 8.8 GW of installed capacity, making it the third-largest power generator in Brazil, while maintaining a high level of contracted energy, which provides stable cash flow. The group has now a large and diversified portfolio of renewable sources, with 54% from hydro, 36% from wind, and 10% from solar plants. Auren's solar and wind plants are located in the northeastern part of the country, and hydro facilities in the state of São Paulo. In our view, the recent acquisition helps to diversify the group's cash generation, reducing its dependence on the Porto Primavera dam, which will now represent about 18% of the installed capacity, down from 42% before the business combination.

Our assessment of Auren's business position also incorporates the stability of its cash flow, as the solar and wind assets of the acquired portfolio have long-term regulated contracts of more than 10 years, while AES Brasil's hydro plants have shorter-term contracts in the free market, given that these concessions mature in 2032. Previously, Auren held a combination of regulated and unregulated contracts for its hydropower assets, the largest of which is CESP. The combined entity should generate 60% of the consolidated EBITDA from long-term regulated contracts in the coming years.

We also expect Auren to capture significant synergies from the business combination, given administrative redundancies, including the ones related to personnel and third-party services, which we are assuming that will result in R$80 million of savings per year. In addition, the streamlined operations would raise availability levels, especially in the acquired portfolio of wind assets, generating additional R$130 million in EBITDA in the next two years.

We still view CESP as the main asset of the group. As such, we will continue assessing it as a core subsidiary of Auren, as pro forma the acquisition, CESP will account for at least 15% of the group's cash flow given its long-term remaining concession life and because Auren manages its subsidiaries in an integrated manner. We analyze Auren, and therefore CESP, on a stand-alone basis, considering the terms of the group's joint control set under the shareholder agreement between Votorantim S.A. (BBB/Stable/--; brAAA/Stable/--) and Canadian Pension Plan Investment Board (CPPIB; AAA/Stable/A-1+).

At the same time, we view Auren as a moderately strategic subsidiary of Votorantim. In our view, Votorantim could provide extraordinary support to the group in a stress scenario because it has a record of providing support to subsidiaries and joint venture entities in events of financial stress. In addition, we view Auren as Votorantim's vehicle to invest in the power sector.

Outlook

Given our assessment of CESP as a core subsidiary of Auren, our ratings on the former reflect the credit quality of its parent company, which drives the latter's business and overall financial strategy. In this context, the stable outlook on CESP reflects our view that Auren is now focusing on absorbing and improving the operational efficiency of the acquired assets. While we anticipate higher leverage initially, the robust cash generation, coupled with a more conservative capital expenditure, should lead to deleveraging in the coming years. We project debt to EBITDA of 5.0x-5.5x and FFO to debt of 7%-10% in 2025 and 2026, improving gradually to about 4.5x and 12%, respectively, in 2027.

Downside scenario

We could downgrade CESP if the creditworthiness of Auren deteriorates, with debt to EBITDA surpassing 5.5x and FFO to debt remaining below 9%. That could occur if the group takes an aggressive stance on debt-funded acquisitions, or if it fails to capture material operational and administrative synergies from the assets it acquired. Finally, we may lower the ratings if hydrological conditions worsen significantly, forcing Auren to purchase energy at higher prices to fulfill its contracts. We could revise downward CESP's stand-alone credit profile (SACP) if debt to EBITDA increases above 4.0x and FFO to debt falls below 20%.

Upside scenario

We do not expect to upgrade CESP in the next 12 months due to the sovereign rating cap. Although unlikely, we could revise upward CESP's SACP if debt to EBITDA falls below 3.0x and FFO to debt ratio surpasses 13%.

Company Description

CESP is a Brazilian electric power generation company that holds the concession for two hydropower plants:

- Porto Primavera, with a capacity of 1,540 megawatts (MW) until April 2056;
- Picada, with a capacity of 39.7 MW, until March 2041; and

In addition, Paraibuna, with an installed capacity of 87 MW, the concession for which is temporary under the terms of the Law 12,783/2013 regarding the extension of concessions and quota regimes, regulated by Portaria 647/2022 of the Ministry of Mines and Energy.

The company is fully controlled by Auren, which in turn is jointly controlled by Votorantim with a 38.7% stake, the CPPIB (30.5%), and the remaining 30.8% freely traded on the São Paulo Stock Exchange.

Rating Component Scores

Rating Component Scores

Component	
Foreign currency issuer credit rating	BB/Stable/--
Local currency issuer credit rating	BB/Stable/--
Business risk	4 - Fair
Country risk	4 - Moderately High Risk
Industry risk	4 - Moderately High Risk
Competitive position	4 - Fair
Financial risk	4 - Significant
Cash flow/leverage	4 - Significant
Anchor	bb
Diversification/portfolio effect	3 - Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile	bb

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings list		
Ratings Affirmed; Outlook Action		
	To	**From**
CESP-Companhia Energetica de Sao Paulo		
Issuer Credit Rating	BB/Stable/--	BB/Watch Neg/--
Brazil National Scale	brAAA/Stable/--	brAAA/Watch Neg/--