Research Update:

Brazilian Generation Co. CESP 'BB-' Rating Affirmed, Stand-Alone Credit Profile Revised Downward On Slower Recovery

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Rating Action Overview

- We expect energy costs to stay high in 2022 because of advance energy purchases in 2021 at higher prices. This, along with weaker economic conditions, will delay recovery of Brazilian hydropower generator CESP-Companhia Energetica de Sao Paulo's credit metrics. We believe CESP will maintain funds from operations (FFO) to debt between 20%-30% and FFO cash interest coverage below 6.0x in the next couple of years.
- As a result, on May 24, 2022, S&P Global Ratings revised downward CESP's stand-alone credit profile (SACP) to 'bb' from 'bb+'. At the same time, we affirmed the 'BB-' global scale and 'brAAA' national scale issuer credit ratings on the company.
- The stable outlook on CESP reflects that on Brazil, given that the sovereign rating caps the company's credit quality.

Rating Action Rationale

The SACP revision reflects that we expect CESP's credit metrics to improve more slowly in the next couple of years. We expect CESP's debt to EBITDA to be 3.0x-3.5x and FFO to debt of 20%-25% in 2022, and about 3.0x and 25%-30% from 2023 onward, which is commensurate with our assessment of a significant financial risk profile, versus our previous expectation of debt to EBITDA below 3.0x and FFO to debt above 30%. In addition, because of higher interest expenses, we see a tighter FFO interest coverage ratio in the next years of 3.0x-6.0x, compared to our previous expectation of above 6.0x. As a result, we revised CESP's SACP to 'bb' from 'bb+'.

The drought damaged CESP's credit metrics in 2021, because the company had to purchase additional energy at higher prices to comply with its power purchase agreements (PPAs) due to inherited energy sales contracts from CESP's previous administration--when it was owned by the state of Sao Paulo--heightened by lower energy generation caused by the drought. In addition, considering the uncertain hydrology for this year, last year CESP made advance energy purchases for 2022 at high prices, in order to mitigate a further deterioration in hydrology, and considering a more conservative Global Scaling Factor (GSF). Coupled with that, rising basic interest rates and inflation increase CESP's interest expenses, which further pressures credit metrics. The company only sells 25% of its assured capacity (230 MW) in the regulated market through longer-term PPAs that are adjusted by inflation annually. It sells the remaining capacity through shorter-term contracts negotiated in the free market bilaterally. From 2023 onward, hydrology remains an uncertainty, and we believe that any worsening in that variable could pressure CESP's credit metrics because the company may have to buy additional energy at higher prices to honor contracts, as occurred last year.

Our adjusted debt incorporates CESP's pension plan deficit of R$1.8 billion. We adjust CESP's debt by the deficit of its defined benefit pension plan, which was hit by high inflation (measured by IGP-M) that remunerates part of the plan's liabilities. CESP is migrating part of its defined benefit pension plan's beneficiaries to a defined contribution plan type (because the company doesn't have the legal obligations to honor actuarial deficits under this pension plan category) in 2022. Twenty percent of beneficiaries opted for the migration and will receive their proportional share once the judicial dispute related to that is concluded. We assume CESP will finance the migration with new debt of roughly R$340 million, which is equivalent to 18% of the pension plan deficit balance. In addition, we believe that the additional debt will bear floating rates tied to interbank deposit rates, which will increase CESP's interest expenses. We'll continue adjusting the R$1.4 billion balance related to the defined benefit pension plan, because the bulk of beneficiaries didn't migrate. This adjustment adds to the company's reported debt of R$2.0 billion in the first quarter of 2022, which consists of two amortizing debentures.

CESP will contribute 70% of Auren's consolidated EBITDA in 2022. The corporate restructuring concluded on March 25, 2022, led to Auren Energia S.A. (Auren; not rated) fully owning CESP's shares, while the latter's minority shareholder exchanged their shares in CESP with Auren's. In the restructuring process, Auren received the energy trading business and minority participation in hydro plants from Votorantim S.A. (Votorantim; global scale: BBB-/Stable/--; national scale: brAAA/Stable/--) and R$1.5 billion in equity from Canada Pension Plan Investment Board (CPPIB), in order to finance its future growth.

Auren's installed capacity now consists of 3.3 gigawatts (GW; 70% of which is hydro and 30% wind--and CESP represents 50% of the total amount), and a pipeline of primarily solar projects totaling 1.9 GW under construction, which we expect to begin operating between 2023 and 2026. In addition, the energy trading business has over 400 clients and reported close to R$4 billion in revenues in 2021. As part of this larger group, CESP will be Auren's main asset, representing about 70% of total EBITDA in 2022 and 50%-60% going forward following the start-up of new projects. We see Auren's diversification toward nonconventional renewables as positive because it lowers hydrology risks and the cash flow reliance on a single asset (the Porto Primavera dam).

Outlook

The stable outlook on CESP reflects that on Brazil, 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. It also incorporates our view that CESP will continue generating solid operating cash flows to cover its working capital needs, will have smooth debt maturities and low capital expenditure (capex) needs, and will keep debt to EBITDA around 3.0x and FFO to debt between 20%-25% in the next 12 months.

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 next 12 months that could lead us to revise downward the SACP further. However, we could revise CESP's SACP downward if hydrology worsens considerably and the company has to buy energy at higher prices to honor its contracts, or if the group pursues a more aggressive financial policy due to new investments or acquisitions, pushing net debt to EBITDA consistently above 4.0x and FFO to debt below 20%.

Upside scenario

We don't expect an upgrade in the next 12 months because of the sovereign rating cap. Although we currently view an upward SACP revision as unlikely, we could do so if CESP's adjusted debt drops, leading to debt to EBITDA below 3.0x and FFO to debt above 30% on a consistent basis. That could happen as a result of much smaller-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: Porto Primavera, with 1,540 megawatts (MW) of capacity until April 2056, and Paraibuna, with 87 MW of installed capacity until June 2022, although CESP will continue operating the latter temporarily.

CESP is fully owned by Auren, which remains jointly controlled by Votorantim S.A. (37.7% stake) and Canadian Pension Plan Investment Board (32.1%; CPPIB), and 30.2% free float listed in São Paulo's stock exchange.

Our Base-Case Scenario

Assumptions

- Inflation--which we link to power contract readjustments and general and administrative expenses--of 10.6% in 2022, 4.9% in 2023, and 3.7% in 2024, in line with our most recent economic research "Global Macro Update: Growth Forecasts Lowered On Longer Russia-Ukraine Conflict And Rising Inflation", published on May 17, 2022.
- A Global Scaling Factor (GSF), which determines the company's level of energy delivery, of 85% from 2022 onward (versus 73% in 2021), assuming more favorable hydrology conditions.
- Operations of Paraibuna plant (48 MW of assured energy) temporarily after the concession expires in June 2022. As announced by CESP, Paraibuna will operate under the quota generation system, receiving fixed revenues of R$22 million annually, adjusted by inflation.
- Power acquired from third parties totaling about 230 MW in 2022 at a cost of roughly R$300/MWh--already fixed under short-term contracts closed in 2021--and 120 MW-150 MW in 2023.
- Annual maintenance capex of about R$13 million.

- Working capital requirements of R$250 million–R$300 million annually, half of which we assume will be used for covering contingent liabilities.
- No acquisitions or major investments.
- Dividends distribution of between 100%-150% in the next couple of years.
- We adjust R$1.4 billion to the company's reported debt to represent the pension plan's deficit position by the end of 2022, incorporating the migration of 18% of beneficiaries to the defined contribution plan.
- We assume CESP will fund the pension plan migration with a new debt issuance of R$340 million.

Key metrics

- Adjusted EBITDA margins of 45%-50% in 2022 and improving to 55%-60% in 2023 and 2024;
- Net debt to EBITDA between 3.0x and 3.5x in 2022 and about 3.0x from 2023 onward;
- FFO to debt between 20%-25% in 2022 and in the 25%-30% range in 2023 and 2024; and
- FFO cash interest between 3.0x-4.0x in 2022 and 4.5x-6.0x in 2023 and 2024.

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 solid 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$602 million as of March 31, 2022; and
- Expected operating cash flows after interest and taxes of R$750 million–R$850 million in the next 12 months.

Principal liquidity uses:

- Short-term debt of R$88 million as of March 31, 2022;
- Working capital outflows of up to R$300 million in the next 12 months;
- Annual maintenance investments of about R$13 million in the next 12 months; and
- Dividend and interest on equity payment of R$450 million in 2022, representing 100% of previous year's net income.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-3, G-2

Environmental and social factors are moderately negative considerations in our credit rating analysis of CESP. The risk of water scarcity at CESP's reservoir is a key rating factor, because dry conditions could harm the company's cash flows if it needed to acquire additional energy on the spot market to honor its energy contracts. In addition, CESP is involved in civil and environmental disputes in areas to which its hydroelectric dam provides electricity.

Group Influence

We analyze Auren, and therefore CESP, on a stand-alone basis, considering the terms of the joint control set under the shareholder agreement between Votorantim and CPPIB, and we don't incorporate any ongoing financial support from the two shareholders in our analysis. At the same time, we view Auren as a moderately strategic entity of Votorantim. In our view, Votorantim could provide last resort extraordinary support to the company under 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 grow in the energy sector.

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: Significant

Cash flow/leverage: Significant

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

Group status: Core to Auren

Related Criteria

- 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
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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	**bb**	**bb+**