FitchRatings

RATING ACTION COMMENTARY

Fitch Removes Auren from Rating Watch Negative; Affirms IDRs

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Fitch Ratings - São Paulo - 14 Nov 2024: Fitch Ratings has removed from Rating Watch Negative and affirmed Auren Energia S.A.'s (Auren) Foreign Currency (FC) and Local Currency (LC) Issuer Default Ratings (IDRs). Fitch has also affirmed the following ratings:

For Auren:

-- National Scale Rating at 'AAA(bra)', Outlook Stable;

-- National Scale Rating of its 3rd and 4th debentures issuances at 'AAA(bra)'.

For Companhia Energetica de Sao Paulo (CESP):

-- National Scale Rating at 'AAA(bra)', Outlook Stable;

-- National Scale Rating of its 12th debentures issuance at 'AAA(bra)'.

Fitch simultaneously removed from Rating Watch Positive and upgraded to 'AAA(bra)' the ratings of the following subsidiaries of AES Brasil Energia S.A. (AES Brasil) and their debentures issuances: Potengi Holdings S.A. (Potengi), Veleiros Holdings S.A. (Veleiros), AES Tucano Holding II S.A. (Tucano II), and Ventos de Santa Tereza 07 Energias Renováveis S.A. (Santa Tereza). A complete list of the rating actions is presented below.

The rating actions follow the closing of AES Brasil Energia S.A.'s (AES Brasil) acquisition by Auren. The affirmation of Auren's ratings reflects Fitch's expectation that Votorantim S.A. (VSA, LC and FC IDRs BBB/Stable), one of its controlling shareholders, would likely support Auren if necessary based on the size and strategic importance of the company to VSA. Fitch also expects that Auren will gradually improve its weaker financial profile that resulted from the acquisition of AES Brasil group.

Auren's Foreign Currency IDR remains constrained by Brazil's 'BB+' country ceiling. The ratings of CESP and AES Brasil's subsidiaries reflect Auren's consolidated credit profile as per Fitch's "Parent and Subsidiary Linkage Criteria."

KEY RATING DRIVERS

Support from VSA: Fitch has incorporated into Auren's ratings the expectation that VSA would support the company if necessary, either from equity injection, dividend flexibility or other means. Auren adds predictability to VSA's dividend stream and has become more relevant to the group following the acquisition of AES Brasil, and offers significant growth opportunities. The anticipated support helps offset the company's high financial leverage resulting from the acquisition.

Highly Leveraged Acquisition: Following the payment of BRL6.4 billion to AES Brasil's shareholders with no equity injection, Fitch projects Auren's consolidated net leverage to grow to 6.2x by the end of 2024 on a pro forma basis, from 1.7x in June 2024, with a gradual reduction to around 5.0x by 2026. High interest rates in Brazil contribute to low interest coverage by EBITDA, estimated at around 1.9x over 2024-2026. Projections assume that Auren will maintain relevant dividend distribution, with flexibility for reduction if necessary.

Stronger Business Profile: The acquisition improves Auren's business scale and asset diversification, with assured energy increasing to 4.0 aGW (+2.3 aGW) based on P-90 certificates and including interests on non-consolidated assets. The contribution from wind assets increases to 35% from 29%, while solar assets' contribution declines to 5% from 9%. This new mix favors the expansion of solar energy, which offers better growth prospects. Auren now has the challenge of replacing almost a third of its portfolio by 2032, when AES Brasil's hydroelectric concessions totaling 1.2aGW will expire. The further growth of the trading business over the long term may pressure margins and add some volatility to cash flows.

Resilience Against Low Prices: Auren's portfolio will remain highly contracted, which will protect cash flows if energy prices remain structurally low, although it could expose the company to high priced purchases in the unlikely scenario of extremely poor hydrology. Projections consider that Auren has already sold 87% of its resources for 2025-2027, including the trading business, internal losses and an estimated 5% haircut on wind and solar generation due to curtailment. About one-third of Auren's energy to be generated by 2025 was sold in the regulated market, which offers higher prices and longer terms compared to bilateral contracts, low counterparty risk and some protection against hydrological risk.

Strong FCFs After 2025: Fitch expects Auren to generate robust free cash flows (FCFs) as of 2026. Adjusted EBITDA should approach BRL3.2 billion in 2024 on a pro forma basis and BRL3.6 billion in 2025, from BRL1.6 billion in 2023, including dividends from non-consolidated companies. Projections incorporate operating synergies averaging around BRL200 million per year, mostly from cost cuts and efficiency improvements in the acquired wind farms.

Fitch expects EBITDA margin to improve to around 30% as of 2027, from the average 24% estimated for 2024-2025, reflecting lower volumes of energy purchase in the trading business. High interest cost, preferred dividends, payments related to CESP's litigations and pension deficits, and the settlement of wind generation deficits should weaken the company's cash flow from operations (CFFO) to levels below 30% of EBITDA until 2026. Fitch projects total investments of BRL2.5 billion through 2026, with more concentrated in 2024.

Subsidiaries Equalized With Auren: The ratings of CESP, Tucano II, Santa Tereza, Potengi and Veleiros reflect Auren's consolidated credit profile, based on the strong incentives that Auren has to support them if necessary. Auren's latest debentures contemplate CESP and AES Brasil in cross-default clauses and AES Brasil guarantees most of the debts issued by Tucano II, Santa Tereza, Potengi and Veleiros.

Fitch also considers the strong operational incentives for all subsidiaries, reflecting the high integration of management and treasury decisions within the group. Strategic incentives vary according to the size of each subsidiary, but each one contributes to optimizing Auren's portfolio, with hydro and wind generation having complementary seasonality patterns.

DERIVATION SUMMARY

The support from VSA justifies Auren having the same Local Currency IDR as Engie Brasil Energia S.A.'s (Engie BR; LC IDR BBB-), which benefits from stronger business profile and lower financial leverage. Engie BR has similar scale, with 8.2 GW and 4.5 aGW in operation, compared to 8.2 GW and 3.8 aGW for Auren, but distributed across a more diversified asset base.

Around 15% of Engie BR's adjusted EBITDA projected for 2025 (BRL6.7 billion) should also come from transmission and gas midstream assets, which add predictability to cash flows. Auren's EBITDA margin is lower than Engie BR's (23% and 66% projected for 2025, respectively) due to the greater importance of the trading business in Auren's consolidated results.

Fitch expects Engie BR to reduce investments as of 2025 and forecasts its net leverage around 3.3x and EBITDA interest coverage around 5.0x in 2025-2026. These levels are much stronger than the averages of 5.0x and 2.0x, respectively, estimated for Auren. Recontracting risk is similar for both companies, having both contracted around 85% of their total resources for 2025-2028, on average. Auren is slightly more exposed to hydrology risk, considering regulatory insurance and energy volumes sold through quotas regime, even though hydro plants contribute around 72% of Engie BR's assured energy and 61% of Auren's.

Auren's LC IDR is the same as AES Andes', which operates a large portfolio of 5.6 GW across Chile (69%), Colombia (20%) and Argentina (11%), including coal plants in Chile and Argentina (40%) - to be mostly decommissioned by 2025 - and hydro plants in Chile and Colombia (37%), as well as wind and solar plants and batteries mainly in Chile (16%). AES Andes operates with higher EBITDA margin, above 40%, and presents financial profile stronger than Auren's. Fitch projects its net leverage around 3.0x in 2025-2026 and EBITDA interest coverage around 3.3x during the same period.

KEY ASSUMPTIONS

-- Generation scaling factor (GSF) of 0.87 in 2024, 0.89 in 2025 and 0.91 in 2026;

-- Wind generation at 95% of P-90 certificates;

-- Effective assured energy of 3.7 aGW in October 2024 and 3.8 aGW as of 2025, proportional to equity interests in the assets;

-- Contracted annual sales from 2024 to 2027, including trading (aGW): 6.7 (pro forma), 5.4, 4.5, and 3.6, respectively;

-- Contracted average prices from 2024 to 2027, including trading (BRL/MWh): 175 (pro forma), 196, 199, and 203, respectively;

-- Prices for new sales contracts of renewable energy in 2024-2027 (BRL/MWh): 179, 232, 201, and 189, respectively;

-- Average short-term prices in 2024-2027 (BRL/MWh): 167, 179, 77, and 137, respectively;

-- Total capex of BRL2.5 billion in 2024-2026, more concentrated in 2024.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

For Auren:

-- An improvement in Brazil's country ceiling could trigger a positive rating action for the FC IDR;

-- Positive rating action for Auren's LC IDR is unlikely in the short term, given Brazil's operating environment.

For Auren's subsidiaries:

-- Upgrades are not possible because the ratings of Auren's subsidiaries are at the top of the national scale.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

For Auren:

-- Weaker incentives of support from VSA;

-- Downgrade of VSA's IDRs;

-- Inability to gradually reduce the consolidated net leverage could trigger a negative rating action on Auren's Local Currency IDR;

--A downgrade of Brazil's sovereign rating could result in a similar rating action on Auren's FC IDR.

For Auren's subsidiaries:

-- A downgrade of Auren's National Scale rating;

-- Weaker support incentives from Auren.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: Fitch expects Auren to maintain comfortable liquidity levels and ample access to several sources of funding despite its high financial leverage. Considering the consolidation of AES Brasil, the BRL7.9 billion raised by Auren in October 2024 and deducting the BRL6.4 billion paid to AES Brasil's shareholders, the pro forma cash balance was BRL9.1 billion at Sept. 30, 2024. This amount covers all debt maturities through 2027 on a pro forma basis. The consolidated debt of BRL29.1 billion was composed of debentures (69%), long-term financing from Brazilian development banks (21%), loans from local banks (8%) and preferred shares partially treated as debt (2%).

ISSUER PROFILE

Auren is a large-sized, publicly traded power generation company in Brazil, with 3.7 aGW of assured energy in operation after the acquisition of AES Brasil. Its co-controlling shareholders are Votorantim Group (38.7%) and the Canadian fund CPP Investments (30.5%).

SUMMARY OF FINANCIAL ADJUSTMENTS

-- Cash collateral and debt-related derivatives treated as debt.

-- Non-controlling interests partially treated as debt.

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.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Potengi Holdings S.A.	Natl LT	AAA(bra) Rating Outlook Stable	Upgrade	AA-(bra) Rating Watch Positive
senior unsecured	Natl LT	AAA(bra)	Upgrade	AA(bra) Rating Watch Positive
CESP - Companhia Energetica de Sao Paulo	Natl LT	AAA(bra) Rating Outlook Stable	Affirmed	AAA(bra) Rating Watch Negative
senior unsecured	Natl LT	AAA(bra)	Affirmed	AAA(bra) Rating Watch Negative
AES Tucano Holding II S.A.	Natl LT	AAA(bra) Rating Outlook Stable	Upgrade	AA-(bra) Rating Watch Positive

senior unsecured	Natl LT	AAA(bra)	Upgrade	AA-(bra) Rating Watch Positive
Auren Energia S.A.	LT IDR	BB+ Rating Outlook Stable Affirmed		BB+ Rating Watch Negative
	LC LT IDR	BBB- Rating Outlook Stable Affirmed		BBB- Rating Watch Negative
	Natl LT	AAA(bra) Rating Outlook Stable Affirmed		AAA(bra) Rating Watch Negative
senior unsecured	Natl LT	AAA(bra)	Affirmed	AAA(bra) Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Lucas Rios, CFA
Associate Director
Primary Rating Analyst
+55 11 4504 2205
lucas.rios@fitchratings.com
Fitch Ratings Brasil Ltda.
Alameda Santos, nº 700 – 7º andar Edifício Trianon Corporate - Cerqueira César São Paulo, SP SP Cep 01.418-100

Rafael Faro
Associate Director
Secondary Rating Analyst
+55 21 3957 3616
rafael.faro@fitchratings.com

Wellington Senter
Director
Secondary Rating Analyst
+55 21 4503 2606
wellington.senter@fitchratings.com

Mauro Storino
Senior Director
Committee Chairperson
+55 21 4503 2625
mauro.storino@fitchratings.com

MEDIA CONTACTS

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 21 Jun 2024)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Auren Energia S.A.	EU Endorsed, UK Endorsed
CESP - Companhia Energetica de Sao Paulo	EU Endorsed, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch’s website.

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