S&P Global Ratings

Ratings **'brAAA'** On Eneva S.A. And Its Debt Affirmed On Proposal To Acquire Focus Energia; Outlook Stable

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Rating Action Overview

- On December 15, 2021, Eneva S.A. (Eneva) announced a business combination agreement with energy trader and renewable project developer Focus Energia Holding Participações S.A. (Focus Energia; not rated) for approximately R$965 million.
- Upon completion of the transaction, which is still subject to conditions precedent, Eneva will increase and diversify its installed capacity by entering the renewable generation segment and will expand its customer base in the trading segment with the customer portfolio of the trading company Focus Energia.
- We believe that Eneva will continue to seek opportunities to grow organically and via acquisitions. As a result, we revised the company's financial risk profile to aggressive from significant, which is mitigated by its growth plan in a more stable business segment such as solar generation.
- As a result, on December 21, 2021, S&P Global Ratings affirmed its national scale issuer and issue ratings 'brAAA' on Eneva. The recovery rating '3' (65%) on the company's debt remains unchanged.
- The stable outlook reflects our expectation that Eneva will continue to generate stable and predictable cash flows, while executing its growth strategy and the investments required to complete the Futura 1 project, and maintaining leverage close to 4,0x in the next 12-18 months.

Rating Action Rationale

If implemented, the acquisition of Focus Energia will strengthen Eneva's competitive position and bring potential gains in synergy and growth. The incorporation of Focus Energia will increase and diversify Eneva's installed capacity, which currently operates exclusively gas and coal thermoelectric assets, once the Futura 1 project, with an installed capacity of 870 megawatts-peak (MWp), is completed. Pro forma the incorporation and ramp-up of the Futura 1 project, we expect Focus Energia to represent between 15%-20% of Eneva's EBITDA. In addition, Eneva will benefit from Focus Energia's customer portfolio, which has more than 1,600 accounts in the free market. This is expected to generate synergies to its gas trading business, considering that Eneva's energy sales contracts currently refer mostly to the regulated market.

The proposed business combination between Eneva and Focus Energia will consist of the merger of the latter by a wholly owned subsidiary of Eneva. The transaction will total an amount of R$715 million, to be paid in cash on the closing date of the transaction, expected for April 2022, and can be extended for three months. In addition, the transaction includes the issuance of 17 million new shares of Eneva that will be offered to Focus Energia shareholders, who will now hold approximately 1.3% of Eneva's equity. The transaction is subject to certain conditions precedent, such as the approval of Brazil's Administrative Council for Economic Defense (CADE) and the approval of the majority shareholders of Eneva and Focus Energia.

Gains of scale and diversification offset the increase in leverage. In our view, the acquisition should increase the group's leverage, with a net debt to EBITDA ratio close to 4.0x and funds from operations (FFO) to net debt between 12%-15% in the next 12-18 months, versus 3.2x and 24.1%, respectively, at the end of September. According to information released by the company, the project's investments (capex) will total R$2.74 billion, of which approximately R$700 million has already been financed with Focus Energia's own equity, and R$1,5 billion will be financed by Eneva, while the remaining balance will be financed with new debt. Futura 1 should contribute to cash generation from the second half of 2022, when it will start operating. The project already has partial long-term power purchase agreements (PPA) and is 93% contracted at average prices of R$172/MWh for the period of 2024-2027. Additionally, the incorporation of Focus Energia provides Eneva with the potential to expand in the solar generation segment, considering the Futura 1 expansion project pipeline, which can reach an installed capacity of up to 3,000 MWp, through an additional capex of R$9 billion.

Additionally, although we do not expect new acquisitions, in addition to Focus Energia in our base case, we believe that Eneva will maintain its growth strategy in the coming years, considering the end of the investment cycle in its assets Azulão-Jaguatirica and Parnaíba V in the first half of 2022, which will already contribute to cash generation throughout 2022. Thus, we believe that the company will continue to seek new growth opportunities organically and via acquisitions, and that it will maintain leverage closer to 4.0x in the coming years. As a result, we assess Eneva's financial risk profile as aggressive, reflecting our expectation that the company will expand its operations in the renewable segment after the incorporation of Focus Energia, and that new acquisitions will be executed over the next few years.

Eneva's cash generation is still concentrated in the Parnaíba complex. The operational start-up of the Azulão-Jaguatirica project diversifies Eneva's cash generation, with around 15%-20% of its gross margin coming from this asset. However, despite the incorporation of Focus Energia, half of the group's gross profit will still depend on cash generation from the Parnaíba complex, which is self-sufficient in gas reserves, but does not have redundancy in the connection of pipelines to transport such gas. We currently view this as a risk that limits Eneva's business risk profile as fair.

In addition, we believe that energy generation in thermoelectric plants will remain Eneva's core activity in the long term, considering its energy sales contracts based on availability in the regulated market, with an average term of approximately 14 years. On December 21, 2021, Eneva contracted 334 MW of power in the first capacity reserve auction for a period of 15 years, which highlights the importance of this segment for the group. Of this total, 39 MW refer to the re-contracting of power from Parnaíba IV (installed capacity of 56 MW), an operational power plant that currently sells energy on the spot market and, therefore, does not require additional investments. The remaining 295 MW refers to new capacity at the UTE Azulão I plant. Planned investments for this new plant are estimated at around R$915 million, which we assume to be executed as of 2023, with a concentration in 2024 and 2025. The Parnaíba IV and Azulão I annual fixed revenues will total R$32 million and R$217 million, as of July 2026.

On the other hand, we view as positive the company's expansion strategy to the renewable generation segment, as announced upon the incorporation of Focus Energia. As such, we will monitor the completion of the merger and the execution of the company's investment strategy over the next 12-18 months as it announces new investments and/or new acquisitions, including potential impacts that more volatile businesses exposed to commodity prices, as is the case of the oil and gas exploration and production segment, may have on their competitive position, as well as the impact of the financing conditions of these possible new acquisitions.

Outlook

The stable outlook reflects our expectation that Eneva will maintain its growth strategy organically and via acquisitions and will expand its operations into the solar generation segment, which is expected to represent between 15%-20% of the group's EBITDA in the next 12-18 months. We expect the incorporation of new assets, combined with strong cash generation from existing assets, to result in a net debt to EBITDA ratio of around 4.0x and FFO to net debt close to 12% over the next 12 to 18 months.

Downside scenario

We would lower the ratings if Eneva presents net debt to EBITDA above 4.0x and FFO to net debt below 12% on a consistent basis over the next few years. These metrics could result from high unavailability of the company's thermal plants, which would pressure its liquidity, as well as from sources of liquidity over uses below 1.2x. We could also downgrade Eneva if the company executes its growth strategy towards more volatile and commodity price dependent business segments, without mitigating factors, or if the company finances new acquisitions mostly with debt, maintaining its leverage levels above the aforementioned limits on a consistent basis.

Upside scenario

Eneva is already rated in the highest national scale category.

Company Description

Eneva S.A. has an integrated business model, operating in the generation of electricity and in the exploration and production of natural gas. The company currently presents installed capacity of 2,295 megawatts (MW), of which 1,429 MW come from four natural gas-fired thermal plants located in the Parnaíba complex, in the state of Maranhão, representing 11% of Brazil's gas-fired thermal generation capacity. The company also owns two coal-fired thermal power plants with an installed capacity of 725 MW and has recently completed the construction of the Azulão-Jaguatirica integrated project, which added 141 MW of natural gas-fired installed capacity to Eneva's generation base. With the completion of the Parnaíba V plant, Eneva's operational installed capacity will total around 2,680 MW in 2022. Additionally, once the acquisition of Focus Energia is completed, Eneva will benefit from solar energy generation, with installed capacity of 670 MW (equivalent to 870 MWp) after the completion of the Futura 1 project. Also, the company is self-sufficient in natural gas, with proved reserves (1P) totaling 29.5 billion cubic meters (bcm), of which 24.2 bcm in the Parnaíba Basin and 5.55 bcm in the Amazon Basin.

Our Base-Case Scenario

Assumptions

- Average inflation, the index of most Eneva's contracts tariffs and part of its costs, of 9.9% in 2021, 5.4% in 2022 and 3.9% in 2023;
- Henry Hub price, the index of part of Parnaíba I contract tariffs, of US$4.50 per million btu (british thermal unit) in 2021, US$3.50 per million btu in 2022 and US$3.00 per million of btu from 2023;
- Coal price, which impacts energy production costs at coal-fired plants (Itaqui and Pecém II), at around US$124/ton (t) in 2021, US$184/t in 2022 and US$60/t from 2023 onwards;
- Average exchange rate of the real against the dollar of R$5.37 in 2021, R$5.48 in 2022 and R$5.55 in 2023;
- Basic interest rate at the end of the year of 9.25% in 2021, 11.25% in 2022 and 8.00% in 2023, impacting Eneva's interest expenses;
- Average availability of thermoelectric plants of 85%-90% and fixed remuneration of approximately BRL 2.3 billion in 2021, increasing to around BRL 3.0 billion – BRL 3.1 billion in 2022 and 2023 , with the operational start-up of the Jaguatirica II and Parnaíba V plants;
- Average dispatch of 77% in 2021, due to the low volumes of reservoirs in Brazil and high thermal dispatch given the drought, around 60%-65% in 2022, considering that the reservoirs will still be in recovery, and between 45%-50% from 2023 onwards;
- Average spot prices (PLD, in the Portuguese acronym) of around R$270/MWh in 2021 and R$150/MWh from 2022 onwards;
- Investments of around R$1.4 billion in 2021, around R$1.2 billion in 2022 and around R$500 million in subsequent years, mainly allocated to the maintenance of existing plants, completion of investments in the Jaguatirica II and Parnaíba V plants in 2022, construction of the Parnaíba VI plant – scheduled to start in 2021 and completion in 2024 – and exploration and development of gas reserves;
- Acquisition of Focus Energia for approximately R$740 million, to be paid in one installment upon closing, expected to take place in April 2022. We also incorporated investments of approximately R$2.0 billion for the completion of the Futura 1 project;
- We expect Focus Energia to contribute with an EBITDA of around R$200 million in 2022 and R$345 million in 2023, considering the operations of the energy trader and the Futura 1 project. The latter should represent around 70% and 85% of Focus Energia's total EBITDA in 2022 and 2023, considering its ramp-up period throughout 2022;
- Our base case does not incorporate the acquisition of the Urucu Complex, as Eneva and Petrobras are still negotiating the terms and conditions of the transaction;
- Due to the volume of accumulated losses in previous years, we consider a dividend distribution of 25% of the net income of the previous year from 2023 onwards, totaling around R$250 million annually.
- EBITDA margins of 37%-40% in 2021 (versus 47.5% in 2020), due to higher gas and coal costs, despite higher dispatch this year, and of 30%-35% in 2022 and 2023, considering the lower margins in the energy trading segment;
- Adjusted debt to EBITDA of around 3.0x in 2021 and around 4.0x in 2022 and 2023;
- FFO to net debt of 20%-23% in 2021 and around 12% in 2022 and 2023, considering higher interest expenses.

Liquidity

We assess Eneva's liquidity as adequate, as we expect the company's liquidity sources to uses to remain above 1.2x over the next 12 months. We also expect net liquidity sources even if EBITDA drops 15% relative to our base-case projection. In addition, our analysis incorporates the company's ability to absorb low-probability, high-impact events over the next two years without the need for refinancing, given the company's extended maturity schedule, with an average term of five years as of September 30, 2021. Despite Eneva's robust cash position of around R$2 billion in the same period and its predictable annual cash flows, as a large part of its revenues are fixed and based on availability, we expect the company to finance the acquisition of Focus Energia of approximately R$740 million and investments in the Futura 1 project partially with debt. Due to its solid operational performance, we understand that Eneva has adequate access to local capital markets and a good relationship with commercial banks, and that funding would not be an issue.

Principal Liquidity Sources:

- Cash and cash equivalents of approximately R$2.0 billion as of September 30, 2021;
- Operating cash generation, after payment of interest and taxes, of R$1.0 billion–R$1.1 billion in the next 12 months;
- New debt contracted in the amount of R$450 million to finance the Futura 1 project.

Principal Liquidity Uses:

- Short-term debt maturities of about R$340 million as of Sept. 30, 2021;
- Contracted and maintenance investments of approximately R$1.5 billion in the next 12 months;
- Intra-year working capital requirements of R$200 million;
- No dividend payments in the next 12 months.

Covenants

Compliance expectations

Some of Eneva's debt contracts are subject to financial covenants, which we expect the company to comply with a cushion of at least 15% over the next two years.

Requirements

The covenants limit the group's consolidated leverage, as measured by the net debt to EBITDA ratio, to below 4.5x. According to its debt indenture, Eneva could report a leverage ratio of up to 5.0x between June 30, 2020 and June 30, 2022, for up to four consecutive or alternating quarters, without resulting in acceleration of its debt, given its investment cycle in that period. After this period, the ratio threshold returns to 4.5x.

Issue Ratings - Recovery Analysis

Key Analytical Factors

The recovery ratings of '3' on Eneva's senior unsecured debentures reflect our average recovery expectation of 65% for the creditors in a hypothetical default scenario. As a result, we equal Eneva's issue ratings to its corporate rating.

Our analysis considers a hypothetical scenario in which a default would occur due to operational issues, resulting in difficulties in refinancing Eneva's debts and leading to potential payment delays. In this scenario, we believe that there would be incentives for the company's restructuring, instead of its liquidation, considering its status as a strategic energy generator for the subsystems in which it operates (North and Northeast), as well as its vertical integration and PPAs. As a result, we would expect higher recovery amounts for the creditors in a restructuring scenario than in the case of liquidation.

In our simulated scenario, a default would occur in 2025, an assumption aligned with that applied to peers rated in Eneva's rating category. We project an emergence EBITDA in the year of default at R$1.5 billion. This, combined with a multiple of 5.5x – which we apply to power generation companies – results in a total gross enterprise value of around R$8.1 billion.

Simulated Default Assumptions

- Simulated default year: 2025
- Approximate emergence EBITDA: R$1.5 billion
- EBITDA Multiple: 5.5x
- Jurisdiction: Brazil

Payment Waterfall

- Net enterprise value (EV) after deducting 5% of administrative costs: R$7.7 billion
- Debt at the operating subsidiaries level: R$3.4 billion
- Total amount available for unsecured debt at the holding level: R$4.3 billion
- Unsecured debt at the holding level: R$ 6.3 billion
- Expected recovery for senior unsecured debt: 65%

*All debt amounts include six months pre-petition interest.

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Ratings Score snapshot

Issuer Credit Rating	
Brazil National Scale	brAAA/Stable/--
Business Risk	Fair
Country Risk	Moderately High
Industry Risk	Moderately High
Competitive Position	Fair
Financial Risk	Aggressive
Cash Flow/Leverage	Aggressive
Modifiers	
Diversification/Portfolio Effect	Neutral
Capital Structure	Neutral
Liquidity	Adequate
Financial Policy	Neutral
Management and Governance	Fair
Comparable Rating Analysis	Positive

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

Related Criteria

- Principles Of Credit Ratings, February 16, 2011
- Environmental, Social, And Governance Principles In Credit Ratings, Oct 10, 2021
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, November 19, 2013
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Corporate Methodology, November 19, 2013
- Corporate Methodology: Ratios And Adjustments, Apr 01, 2019
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- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Methodology: Industry Risk, November 19, 2013
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- Group Rating Methodology, July 1, 2019
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014

Related Research

- S&P Global Ratings Definitions