

Research Update:

Jalles Machado S.A. Upgraded To 'BB' From 'BB-' On Stronger Liquidity And Lower Leverage After IPO, Outlook Stable

February 8, 2021

Rating Action Overview

- On Feb. 5, 2021, Brazil-based sugarcane processor, Jalles Machado S.A. (Jalles), completed its IPO on the Brazilian Stock Exchange, raising about R\$590 million in the primary offer, which will help to further strengthen the company's liquidity and credit metrics.
- We expect Jalles to maintain its sound operating efficiency and flexibility, with low cash cost of production and higher value-added portfolio of products throughout industry cycles, while it expands organically and through acquisitions, funded by the IPO proceeds.
- On Feb. 8, 2021, S&P Global Ratings raised its long-term issuer credit rating on Jalles to 'BB' from 'BB-' on the global scale and to 'brAAA' from 'brAA+' on the national scale. The outlook on both scales is stable.
- The stable outlook reflects our expectation that Jalles will maintain its adjusted debt to EBITDA consistently well below 2.0x, funds from operations (FFO) to debt well above 45%, and slightly positive free operating cash flow (FOCF) to debt, despite the sizeable expansion investments in the next three years.

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Rating Action Rationale

IPO will enable growth. The company will use slightly over half of the proceeds to expand the crushing capacity of its cluster in the state of Goiás from 5.3 to nearly 6.5 million tons of sugarcane per harvest in the next three years. Jalles will use the remaining proceeds to acquire a mill in another state. This will enhance Jalles' scale and geographic diversification, although operating efficiency could slip from the company's historically high standards, as it adjusts the new mill's operations.

Maintenance of lower leverage. The cash inflow, combined with expected high cash generation from record-high sugar in reals and favorable ethanol prices, as well as Jalles' operational flexibility to shift its production mix between sugar and ethanol and its product diversification into

organic sugar, anhydrous ethanol, and sanitizers will enable the company to maintain its leverage low despite the acquisition and expansion investments. We expect the company to continue maximizing the production of sugar because its price differential compared with ethanol remains favorable, although ethanol prices remain robust given the weaker real and the recovery in oil prices.

Jalles has maintained resilient liquidity, which the IPO bolstered. Jalles has kept a comfortable liquidity cushion against the industry volatility for the past few years, gradually extending overall debt maturities even amid the COVID-19 pandemic. The IPO will further strengthen the company's liquidity, with more than enough cash to cover maturities for the next four years. This prompted us to revise our liquidity assessment on Jalles to adequate.

Outlook

The stable outlook reflects the expectation that Jalles will maintain low leverage, despite the potential acquisition of a mill and the higher expansion capital expenditures (capex) in the next three years. Jalles should continue operating at full capacity and benefiting from high sugar prices in reals and profitable ethanol prices. The company has also strengthened its capital structure and liquidity with the IPO proceeds, and we expect it to continue extending maturities and reducing its funding costs. We expect Jalles to maintain adjusted debt to EBITDA at 1.0x-1.5x, FFO to debt above 60%, and slightly positive FOCF in the next few years even as it increases investments.

Downside scenario

A negative rating action in the next 12 months would stem from adverse climatic conditions that hamper the company's operating efficiency amid high expansion investments, resulting in significant FOCF shortfalls. A downgrade is also possible if Jalles pursues a more aggressive acquisition or shareholder remuneration strategy. In this scenario, adjusted debt to EBITDA would reach above 2.0x and FFO to debt below 45%. We could also downgrade Jalles if its liquidity weakens and it's unable to pass our sovereign stress scenario to have a rating higher than that on Brazil (BB-/Stable/B), or if on a stand-alone basis, cash sources for the next 12 months don't exceed its uses at least by 20%.

Upside scenario

An upgrade in the short term is unlikely given the company's smaller scale than those of peers. We could raise the ratings in the next 18-24 months if the company expands its scale and geographic footprint, while maintaining its operating efficiency, strengthening its FOCF. At the same time, Jalles would maintain a track record of cash sources exceeding its uses by at least 20% for the 12 months, even amid volatility in commodity prices and the seasonality of the harvest.

Company Description

Jalles is a Brazilian sugarcane processor located in the state of Goiás, with crushing capacity of almost 5.5 million tons of sugarcane per harvest. The company operates two mills--Jalles Machado and Otávio Lage--where it produces sugar (organic, crystal, and VHP) ethanol (anhydrous and hydrated), sanitizers, and dry yeast. The company also cogenerates energy, but it

sold a majority stake in its cogeneration assets at both mills to Albioma. Its two plants are located only about 60 kilometers from each other, which results in synergies in logistics and cane sourcing. For fiscal 2021 ending March 31, the company will crush about 5.3 million tons of sugarcane and post net revenue of nearly R\$1 billion.

The company is now listed on the Brazilian Stock Exchange, and will expand crushing capacity to more than 6 million tons at its two existing mills and plans to acquire a third one in another Brazilian state with about 2 million tons of capacity. This will increase consolidated capacity to more than 8 million tons of sugarcane per harvest in the next two to three years.

Table 1

Jalles Machado S.A. -- Financial Summary

Industry Sector: Agribusiness

	--Fiscal year ended March 31--				
	2020	2019	2018	2017	2016
(Mil. R\$)					
Revenue	891.3	762.2	736.5	708.5	716.5
EBITDA	611.2	550.4	542.6	530.6	519.0
Funds from operations (FFO)	494.6	428.9	412.8	384.1	398.1
Interest expense	130.8	146.6	174.2	150.6	125.3
Cash interest paid	113.7	118.7	125.4	139.4	114.0
Cash flow from operations	592.4	393.6	390.3	385.3	507.4
Capital expenditure	391.2	403.9	360.6	392.9	272.1
Free operating cash flow (FOCF)	201.3	(10.4)	29.7	(7.6)	235.3
Discretionary cash flow (DCF)	198.0	(10.4)	29.7	(8.3)	234.8
Cash and short-term investments	419.0	343.3	441.1	334.2	271.1
Gross available cash	419.0	343.3	441.1	334.2	271.1
Debt	1,313.3	1,152.3	1,097.1	1,068.5	1,006.1
Equity	601.2	527.1	454.3	408.0	302.2
Adjusted ratios					
EBITDA margin (%)	68.6	72.2	73.7	74.9	72.4
Return on capital (%)	16.7	13.8	13.0	14.7	15.7
EBITDA interest coverage (x)	4.7	3.8	3.1	3.5	4.1
FFO cash interest coverage (x)	5.4	4.6	4.3	3.8	4.5
Debt/EBITDA (x)	2.1	2.1	2.0	2.0	1.9
FFO/debt (%)	37.7	37.2	37.6	36.0	39.6
Cash flow from operations/debt (%)	45.1	34.2	35.6	36.1	50.4
FOCF/debt (%)	15.3	(0.9)	2.7	(0.7)	23.4
DCF/debt (%)	15.1	(0.9)	2.7	(0.8)	23.3

Table 2

Jalles Machado S.A.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts

--Rolling 12 months ended Sept. 30, 2020--

Jalles Machado S.A. reported amounts (mil. R\$)

	Debt	Shareholders' equity	Revenue	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Dividends	Capital expenditure
	1,585.9	631.4	987.4	660.7	349.2	65.4	621.1	449.3	18.5	231.2
S&P Global Ratings' adjustments										
Cash taxes paid	--	--	--	--	--	--	(3.0)	--	--	--
Cash interest paid	--	--	--	--	--	--	(105.1)	--	--	--
Reported lease liabilities	417.8	--	--	--	--	--	--	--	--	--
Accessible cash and liquid investments	(754.5)	--	--	--	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	--	(11.2)	--	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	--	(1.6)	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	--	0.2	0.2	--	--	--	--	--
EBITDA: Other	--	--	--	(39.8)	(39.8)	--	--	--	--	--
Working capital: Other	--	--	--	--	--	--	--	153.3	--	--
Capital expenditure: Other	--	--	--	--	--	--	--	--	--	153.3
Total adjustments	(336.7)	0.0	0.0	(39.6)	(50.8)	0.0	(108.1)	151.7	0.0	153.3
S&P Global Ratings' adjusted amounts										
	Debt	Equity	Revenue	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends	Capital expenditure
	1,249.2	631.4	987.4	621.1	298.4	65.4	513.1	601.1	18.5	384.5

Our Base-Case Scenario

- Brazil's average inflation of 3.9% in 2021 and 3.5% in 2022, affecting labor-related costs (harvesting, transportation, and industrial costs).
- Average exchange rate of R\$5.30 per \$1 in 2021 and R\$5.17 per \$1 in 2022.
- Average VHP sugar prices of slightly more than R\$1,270 per ton in fiscal 2021, rising to R\$1,610 per ton in fiscal 2022, according to the company's hedged prices, forward curves for the NY#11 contract, and the foreign exchange rate.
- Average organic sugar prices close to R\$3,200 and R\$3,500 per ton in fiscals 2021 and 2022, respectively.
- Average white sugar prices of slightly more than R\$1,400 and R\$1,750 per ton in fiscals 2021 and 2022, respectively.
- Average anhydrous and hydrated ethanol prices in fiscal 2021 of R\$2.00 and R\$2.14 per liter, respectively, changing according to the international oil prices and the average foreign exchange rate.
- Net proceeds from the IPO of about R\$590 million in fiscal 2021.
- Consolidated crushing levels of about 5.3 million tons of sugarcane in fiscals 2021 and 2022, increasing to about 7.7 million in fiscal 2023 after the acquisition of a third mill and internal expansion.
- Total capex, including expansion and crop treatment, of about R\$400 million in fiscal 2021, and increasing to about R\$640 million and R\$740 million in fiscals 2022 and 2023, respectively.
- Acquisition of a third mill in fiscal 2023 for about R\$350 million, with capacity to crush about 2 million tons of cane per year.
- Dividend payouts of 25% of the previous year's net income in fiscal 2021 and nearly 50% afterwards.

Liquidity

We're revising our liquidity assessment on Jalles to adequate. The company has a track record of cash sources exceeding its uses by more than 20% in the past three years, and extended debt maturities even during the pandemic. Moreover, the cash proceeds from the IPO will strengthen Jalles' cash position for the next 12 months. Although the proceeds would be mostly used for organic and inorganic growth, we expect Jalles to continue maintaining such a cushion in the future.

Principal Liquidity Sources:

- Cash position of R\$742.7 million as of Sept. 30, 2020;
- FFO of about R\$575 million in the next 12 months after Sept. 30, 2020; and
- IPO proceeds of R\$590 million.

Principal Liquidity Uses:

- Short-term debt of R\$454.8 million as of Sept. 30, 2020;

- Working capital requirements of about R\$5 million in the next 12 months after Sept. 30, 2020;
- Capex of about R\$520 million in the next 12 months after Sept. 30, 2020; and
- Dividend distribution of 25% of the previous year's net income.

Covenants

Compliance expectations

Jalles complied with all of its covenants, which are measured annually, as of March 31, 2020. We currently forecast a cushion of more than 50% on the company's covenants for the next few years.

Requirements

The company has payment acceleration covenants on its debt that require net debt to EBITDA of below 3.0x and EBITDA interest coverage ratio higher than 2.5x.

Environmental, Social, And Governance

Social factors benefit Jalles' credit profile to a greater degree than those of its peers, given that the company is one of few organic sugar producers in the world--a niche product for which the price premium over standard sugar is high, compensating for a possible decline in non-organic sugar consumption in the future. Jalles also has high flexibility to shift its production mix toward ethanol, if profitability of the biofuel demands it.

The impact of environmental factors on our rating on Jalles is in line with that of the sugar and ethanol (S&E) industry. S&E producers in Brazil benefit from the government program, Renovabio, which aims to increase biofuel production in Brazil. The program measures the sustainability of companies' operations, remunerating mills through carbon certificates (CBIOs) according to the amount of carbon emissions in their processes for each liter of biofuel produced. The sector is prone to adverse climate conditions that can depress agricultural productivity, particularly droughts and extremely rainy periods, which can prevent companies from crushing available sugarcane in their fields. However, Jalles mitigates weather risks by its irrigation capacity.

Ratings Score Snapshot

Issuer Credit Rating

- Global Scale: BB/Stable/--
- Brazil National Scale: brAAA/Stable/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Fair
- Comparable rating analysis: Neutral

Related Criteria

- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Upgraded

	To	From
Jalles Machado S.A.		
Issuer Credit Rating	BB/Stable/--	BB-/Stable/--
Brazil National Scale	brAAA/Stable/--	brAA+/Stable/--

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