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Research Update:

Emgesa S.A. E.S.P. 'BBB' Ratings Affirmed; Outlook Still Negative

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Overview

- Colombia-based power generator, Emgesa, and its sister company electricity distributor, Codensa, have maintained key credit metrics in line with our expectations despite the drought stemming from the El Nino phenomenon.
- We're affirming our 'BBB' corporate credit and issue-level ratings on Emgesa.
- The negative outlook reflects the one on Colombia. We expect Emgesa and Codensa will post debt to EBITDA below 2.0x and funds from operations (FFO) to debt above 30% for the next two years.

Rating Action

On Aug. 22, 2016, S&P Global Ratings affirmed its 'BBB' corporate credit and issue-level ratings on Emgesa S.A. E.S.P. The outlook on the corporate credit rating remains negative.

Rationale

Emgesa was able to maintain its key credit metrics despite the El Nino phenomenon, which occurred between the second half of 2015 and the second half of 2016. The decrease in the Colombia's reservoir levels resulted in a greater need for thermal generation, and which allowed to increase revenue by 18% given higher prices in the Colombian electric spot market coupled with stable performance of the distribution business. Emgesa posted debt to EBITDA of 1.6x and FFO to debt of 37.6% in 2015, which were in line with our current assessment of its financial risk profile. Please note that the analysis on Emgesa is based on our consolidated figures on Emgesa and Codensa.

We view Emgesa's credit quality as integrally linked with that of its sister company, Colombia's largest electric distribution company, Codensa S.A. E.S.P. (not rated), because of both companies' significant integration, including shared management, support units, and ownership, and the possibility of intercompany loans to optimize cash allocation and diversify funding sources. In addition, Codensa has a similar ownership and governance structure to that of Emgesa. Therefore, we follow a consolidated approach in our credit analysis of Emgesa.

Emgesa's 'bbb+' stand-alone credit profile (SACP) reflects our view of the company's satisfactory business risk profile, modest financial risk profile, and adequate liquidity. The rating on Colombia limits that on the company because a sovereign default scenario could impair Emgesa's and Codensa's finances.

Emgesa's satisfactory business risk profile is based on the company's satisfactory competitive position because it's the second-largest power generator in Colombia by installed capacity, its diversified asset base through the ownership of 13 power plants, low generation costs. It also considers Codensa's leading market position as the largest electric distribution company in the country, and favorable regulatory framework, which allows it to pass through the cost of power purchases to end users. Emgesa benefits from an adequate operating efficiency and strong profitability. With a total installed capacity of 3,459 megawatts (MW), Emgesa provides power to about 20% of the national interconnected system. In addition, Codensa sells about 15,000 gigawatt hours (GWh) annually to about three million customers, which represent an about 23% market share in terms of electricity sales.

Our assessment of Emgesa's financial risk profile as modest mainly reflects the company's strong consolidated cash flow generation and healthy financial metrics (consolidated with those of Codensa). We expect debt to EBITDA of less than 2.0x and FFO to debt of above 30% by the end of 2016 and in 2017. We also expect free operating cash flow (FOCF) to debt to reach about 10% by the end of this year.

Our base-case scenario assumes the following factors:

- Colombia's GDP growth of 2.3% and 3.0% for 2016 and 2017, respectively, and electricity demand growth at 3%-4% during the next two years, which would support the company's growth prospects.
- EBITDA generation growth of 3.0% and 13.5% in 2016 and 2017, respectively. The 2016 results will incorporate a full year of operations at Emgesa's 400 MW hydroelectric plant, Quimbo, , adding about 2,200 GWh of low-cost power generation per year.
- Codensa's tariff to be revised in 2016, which was originally slated for January 2015. The revision would reduce Codensa's revenue in 2016, but it shouldn't weaken Emgesa's healthy credit metrics.
- A 4% decrease in revenues in 2016, given spot price in the Colombian electricity market are expected to be lower in 2016 after the El Nino phenomenon.
- Capex of about COP1.1 trillion in 2016 and COP800 billion for 2017, mainly for maintenance works at Emgesa's thermal plants and maintenance and growth of Codensa's network,
- A 100% dividend payout.

Based on these assumptions, we arrive at the following credit measures for 2016 and 2017:

- Net debt to EBITDA below 2.0x;
- FFO to net debt above 30%; and
- FOCF to debt above 20%.

Liquidity

We assess Emgesa's liquidity as adequate. We expect consolidated liquidity sources (including those at Codensa) to exceed uses by at least 1.2x in the next two years, which provides protection against adverse events. We also expect sources to exceed uses even if EBITDA were to decline by 15%. Our assessment also incorporates the company's financial flexibility, as seen in its fluid access to credit markets. It can also retain discretionary cash by reducing its large dividends. In addition, Emgesa is not subject to financial covenants on their outstanding bonds as long as they are rated in the investment grade category. However, Codensa has a financial covenant of net debt to EBIDTA of 3.5x until 2020, which is in compliance as of Jun 30, 2016.

Emgesa and Codensa's principal liquidity sources for the following 12 months after June 30, 2016 are:

- Cash balance and short-term investment of COP552 billion (as of June 30, 2016); and
- FFO of about COP2.2 trillion.

Principal liquidity uses for the following 12 months after June 30, 2016:

- Short-term debt of about COP1.1 trillion(as of June 30, 2016);
- Capital expenditures of about COP944 billion; and
- A 100% dividend payout policy.

Other modifiers

On an aggregate basis, the modifiers don't affect the rating.

Group influence

Empresa de Energia de Bogota S.A. E.S.P. (EEB; BBB-/Negative/--), holds the majority of Emgesa and Codensa's common stock. Enersis Américas S.A. (Enersis Américas; BBB/Negative/--) holds 56.4% of Emgesa's voting shares. Therefore, we consider Emgesa to be a member of the Enersis Americas' economic group.

We consider Emgesa as a core subsidiary for Enersis Américas given that the Colombian operations represent its most relevant market. Enersis Américas has the right to appoint three out of seven of the company's board of directors, two by EEB and two independent members . Nevertheless, the approval of any decision related to the sale of Emgesa's assets and any decision related to transactions of any sort with related parties exceeding $5 million require five votes. We believe this structure limits the financial impact on Emgesa that could result from a potential impairment of Enersis Américas' financial profile. Therefore, under our group rating methodology, we consider Emgesa as an insulated subsidiary of Enersis Américas.

Outlook

The negative outlook on Emgesa reflects the one on Colombia, given our view that ratings on the latter limit those on the former. The negative outlook

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reflects the risk that Colombia's fiscal and external positions could deteriorate further, beyond our base-case expectations, if the government is unable to advance with fiscal measures this year that would help stabilize its recently rising debt burden and reduce economic imbalances. We expect Emgesa to maintain its key credit metrics, with debt to EBITDA below 2.0x and FFO to debt above 30% for the next two years.

Downside scenario

A negative rating action on Colombia would lead to a similar action on Emgesa. We could lower the ratings if the peace negotiations between the government and the country's main guerrilla group flounder or political challenges weaken the government's fiscal belt-tightening. If, contrary to our expectations, the peace process suffers marked setbacks, the government may find it more challenging to take timely and adequate fiscal steps, especially amid a decelerating economy. Under such a scenario, the government's debt burden would rise and would likely further erode Colombia's weakened external profile, resulting in a downgrade.

We could also lower Emgesa if it generates consistently lower-than-expected cash flow that could pressure its financial metrics and/or if it implements a more aggressive expansion plan, which results in total debt to EBITDA of more than 3.0x and FFO to debt of less than 30%.

Upside scenario

The rating on Colombia limits any upgrade potential because we believe a sovereign default scenario could undermine Emgesa's finances. Therefore, a positive rating action would require a positive rating action on Colombia while Emgesa's financial performance meets our expectations.

The ratings could stabilize, if, in line with our base case, the peace process advances, facilitating the government's ability to bolster fiscal prospects with a combination of spending cuts and increased revenues. In addition, successful implementation of projects associated with the government's "4G" infrastructure program would help sustain GDP growth, partly compensating for the negative impact of low commodity prices, contributing to economic stability and fiscal revenues.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Negative/--

Business risk: Satisfactory

- Country risk: Moderate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+
Group credit profile: bbb+
Entity status within group: Core

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Emgesa S.A. E.S.P.	
Corporate Credit Rating	BBB/Negative/--
Senior Unsecured	BBB

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.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.