RATING ACTION COMMENTARY

Fitch Affirms Emgesa's IDR at 'BBB'; Outlook Negative

Wed 31 Mar, 2021 - 2:06 PM ET

Fitch Ratings - New York - 31 Mar 2021: Fitch Ratings has affirmed Emgesa S.A. E.S.P.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB'. The Rating Outlook on the Foreign Currency IDR is Negative and Local Currency IDR Outlook is Stable. Fitch also affirmed the company's Long-Term National Scale rating at 'AAA(col)' with a Stable Outlook.

Emgesa's ratings reflect the company's strong business model, supported by asset diversification, solid competitive position and consistently strong cash flow from operations. The company maintains robust cash flow generation, which along with expectations of limited capex execution, underpins Fitch's expectations for the company to maintain low financial leverage in the medium term. The company's adequate liquidity position and strategic importance to its shareholders are also factored into the ratings.

Emgesa's foreign currency ratings are constrained by Colombia's Country Ceiling of 'BBB'. The Negative Outlook on the foreign currency ratings reflect the Negative Outlook on Colombia. Emgesa operates within Colombia and do not have substantial offshore cash or EBITDA from other countries.

KEY RATING DRIVERS

Solid Business Position: Emgesa's ratings reflects its robust business position in the electric generation market in Colombia. As of December 2020, the company remained as the largest generation company in Colombia in terms of installed capacity and the second largest in electricity generated. The company has a well-diversified portfolio of plants: 12 hydro and two thermal units. Total capacity remains at 3,506MW, making up 20% of Colombia's generation matrix. The scale and diversity of its asset base gives the company higher operational flexibility relative to smaller and less-diversified generation companies (GenCos), and improves predictability to the operational cash flow.

Conservative Capital Structure: Fitch expects Emgesa to maintain positive FCF generation under normal hydrology conditions over the medium term, driven primarily by annual EBITDA of COP2.0 trillion-COP2.5 trillion and limited capex requirements. The dividend pay-out ratio is expected to average 90% over the rating horizon, in line with the recent dividend distribution approved by the company. Emgesa's leverage is forecasted to average 1.0x over the rating horizon in the absence of sizable projects.

Moderate Business Risk: Emgesa's matrix size and diversification mitigate the risk of operating in the competitive electric generation business in Colombia, which depends on hydrology conditions as well as energy and fuel prices. Colombia's electricity sector operates under a shorter-term contract structure relative to other countries in the region. Emgesa combines geographic diversification and backup thermal generation capacity totalling 409MW help to mitigate the hydrological risk given the portfolio is heavily weighted (88%) to hydro generation. Annual capacity payments between USD220 million and USD230 million stemmed from the Firm Energy Obligations awarded make up roughly 19% of the company's total revenues. These capacity payments add to the company's cash flow stability.

Exposure to Hydrological Risk: Emgesa mitigates this risk through geographic diversification of its generation matrix, operation of thermal assets and contractual energy purchases. The diversification in different basins allows the company to maintain stability in energy generation amid severely dry seasons. The company's commercial policy aims to maintain contract sales at 80%-85% of its sales mix. Emgesa's current generation matrix could expose it to some cash flow volatility under scenarios of adverse hydrology conditions or major disruptions to one of its larger plants, which could force the company to purchase energy in the spot market at higher prices to fulfill contractual obligations.

Standalone Approach: Emgesa's credit rating profile is based on a standalone basis. Emgesa is a strategic investment for its controlling shareholder, Enel S.p.A (A-/Stable) through Enel Americas S.A. (A-/Stable) given the importance of Enel's Colombian operations in terms of EBITDA. Enel America's Colombian electricity generation and distribution operations made up roughly 26% of the EBITDA generated in the region during 2020. The absence of legal ties, weak to moderate operational ties and the presence of an important minority shareholder, nonetheless, weakens the parent-subsidiary linkage.

Shareholder Dispute: The arbitrage process initiated by Grupo Energia Bogota S.A. E.S.P. (GEB) against Enel Americas, which relates to Emgesa's dividend-distribution policy, as well as related party transactions appears to be manageable. On Jan. 29, Enel Americas signed a new investment framework agreement with GEB which would allow the integration of the renewable business into their joint investments, define new corporate governance rules and propose settlement agreements for the existing arbitration claims between both entities. While there is still limited visibility as to the potential impact of the resolution on the arbitrage process and the new investment framework agreement, Emgesa's credit profile could withstand reasonable adverse resolution scenarios.

DERIVATION SUMMARY

Emgesa is well positioned relative to regional investment-grade electric company peers, including Isagen S.A. E.S.P. (BBB/Negative), Enel Generacion Chile S.A. (A-/Stable), Engie Energia Chile S.A. (BBB+/Stable), Colbun S.A. (BBB+/Stable) and AES Gener S.A. (BBB-/Stable). All of these companies benefit from predictable cash flow from operations, stemming from robust business profiles and conservative capital structures.

Differences in specific rating levels are largely a function of revenue mix, both geographically and by business, along with asset base diversification and the presence of long-term contract sales. Enel Generacion Chile has the largest installed capacity within these peers, with more than 6,000MW distributed among hydroelectric, thermal and wind farms. Additionally, leverage has averaged 1.5x. Enel Americas' ratings reflect strong and sustained credit metrics coupled with a solid business platform, as well as a strong degree of business and geographical diversification across Latin America. Emgesa's leverage is expected to average 1.0x, below estimations for Colbun and Engie (2.0x).

Emgesa also compares well with electricity generation peers that have national ratings, namely Isagen, Empresas Publicas de Medellin E.S.P. (EPM) and Celsia Colombia S.A. E.S.P., all rated 'AAA(col)'. Emgesa has the highest installed capacity and the most conservative capital structure within this group. Fitch projects Isagen and Celsia Colombia's leverage to average 3.3x and 3.0x, respectively, in the medium term. EPM's credit profile benefits from diversification across business sectors and geographies, which contributes to solid and predictable cash flows. EPM's ratings are nevertheless on Rating Watch Negative as a result of continued uncertainty regarding the development of the Ituango project.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer Include:

--Emgesa's electricity generation remains around 14,000 gigawatt hours during 2021-2024;

--Emgesa's commercial policy maintains contract sales between 80% and 85% of total volume sales;

--Capex focused on existing assets. No material increase in installed capacity is considered;

--Dividend payout ratio of 90% during 2021-2024.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Fitch considers a positive rating action unlikely in the near term, given business and geographic concentration in electricity generation in Colombia.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A steep decrease in electricity prices, coupled with low generation and poor electricity demand that put significant pressure on EBITDA generation;

--Changes in regulation that put pressure on Emgesa's cash flow operation capacity;

--Sustained increase in leverage above 3.5x;

--A change in the company's strategy resulting in more aggressive leverage, capex or acquisitions;

--A downgrade of Colombia's Country Ceiling.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: Emgesa's liquidity is adequate, supported by healthy cash balance, stable cash flow from operations, limited capex requirements and manageable debt maturity profile. As December 2020, the company reported approximately COP820 billion of available cash and approximately COP828 billion in short-term debt. In January 2021, the company paid-in-full its COP736,760 million international bonds.

Emgesa's debt refinancing risk is low, given its moderate leverage, the manageable debt profile and ample access to liquidity sources. As of December 2020, the company reported available uncommitted credit lines of COP2.8 trillion jointly with its related company, Codensa S.A. E.S.P., and has proven access to local and international capital markets, which reinforce its liquidity position. In March 2020, the company added a 12-month committed credit line for USD65 million as liquidity support, if necessary.

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.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Emgesa S.A. E.S.P.	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Outlook Negative
	LC LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
	Natl LT	AAA(col) Rating Outlook Stable	Affirmed	AAA(col) Rating Outlook Stable
	Natl ST	F1+(col)	Affirmed	F1+(col)
• senior unsecured	Natl LT	AAA(col)	Affirmed	AAA(col)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

National Scale Rating Criteria (pub. 22 Dec 2020)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

Feedback

ENDORSEMENT STATUS

Emgesa S.A. E.S.P.	EU Endorsed, UK Endorsed

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