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## Research Update:

# Emgesa S.A. E.S.P. Outlook Revised To Stable From Negative On Expected Parent Support; 'BBB' Rating Affirmed


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## Overview

- We're affirming our 'BBB' corporate credit and issue-level ratings on Colombia-based power generator Emgesa.
- We're also revising the outlook on Emgesa to stable from negative based on our expectation that its controlling parent Enel Americas S.A. (BBB/Stable/--) would support it in a scenario of sovereign stress.
- The stable outlook on Emgesa reflects our expectation that the company will continue to post debt to EBITDA below 2.0x and funds from operations (FFO) to debt above 30% in the next two years, as well as our assessment that Emgesa will remain a core subsidiary to Enel Americas and that the latter's credit worthiness will not deteriorate in the next two years.

## Rating Action

On Aug. 31, 2017, S&P Global Ratings revised the outlook on Emgesa S.A. E.S.P. to stable from negative. At the same time, we affirmed its 'BBB' corporate credit and issue-level ratings.

## Rationale

The outlook revision to stable reflects that we consider Emgesa a core subsidiary of Enel Américas, its controlling shareholder. We consider Enel Americas to be able and willing to sufficiently support Emgesa even during stress from a sovereign default. Therefore, the ratings on Emgesa and the outlook now reflect those on its parent, and are no longer capped by the Republic of Colombia (foreign currency BBB/Negative/A-2; local currency BBB+/Negative/A-2) sovereign ratings, according to our Group Rating Methodology. Enel Américas holds 56.4% of Emgesa's voting shares, while Empresa de Energia de Bogota S. A. E. S. P. (EEB; BBB-/Stable/--) holds the majority of its common stocks.

In applying our Group Rating Methodology on Emgesa, we incorrectly analyzed it on a consolidated basis with its sister company Codensa S.A. E.S.P (not rated) to determine its stand-alone credit profile (SACP). Therefore, we're now analyzing Emgesa on its own to determine its SACP. This new analysis changed the company's financial risk profile to intermediate from modest and its SACP to 'bbb' from 'bbb+', because Codensa has lower debt levels and overall low financial leverage. But this change alone does not impact the final ratings on

Emgesa.

Going forward, we expect Emgesa's SACP to be supported by a 14,544 gigawatt hour (GWh) energy generation in 2017 that will result in EBITDA of approximately Colombian peso (COP) 1.9 trillion, with a 57% EBITDA margin. We expect Emgesa to maintain its commercial strategy of selling the majority of its capacity through medium-term contracts with distributors and large consumers, while keeping its spot market sales and thermal capacity as a hedge for hydrology risk, as seen during the El Niño climate pattern that started in 2015 and finished in mid-2016. This strategy enabled the company to mitigate the hydrology risk and maintain stable cash flow generation, posting a 7.5% increase in revenue from higher spot prices, debt to EBITDA of 2x, and FFO to debt of 26% at the end of 2016.

Emgesa is the second-largest power generator in Colombia by installed capacity, providing power to about 20% of the national interconnected system with 3,467 megawatts, of which 89% is hydro-based. The company benefits from a diversified asset base: it owns 13 power plants, of which 11 are hydro plants and two are thermal plants (oil-gas and coal). Emgesa also benefits from its large and low-cost hydropower generation, efficient operations (average availability level of above 90% in the last three years), and a stable regulatory environment.

Our base-case scenario assumes the following factors:

- In 2017 and 2018, respectively, Colombian GDP growth of 1.7% and 2.2% (increasing the demand for energy), and a consumer price index (CPI) of 4.0% and 3.8% (influencing costs and energy prices).
- Energy revenue to decrease by 2% in 2017, following the plunge of spot market prices in uncontracted energy sales, to an average of COP129/kWh in the first quarter of 2017 from over COP650/kWh in the first quarter of 2016. A more favorable hydrology combined with a lower hydrocarbon commodity price prompts this decrease.
- Improvement of EBITDA margins to 57% in 2017, based on normal hydrology.
- Capital expenditures (capex) of about COP300-450 billion in the next two years, mainly for maintenance of Emgesa's thermal plants and expansion of the Termozipa plant's useful life; and
- A 100% dividend payout.

Based on these assumptions, we expect the following credit metrics for 2017 and 2018:

- Net debt to EBITDA below 2.0x;
- FFO to net debt of 25% in 2017 and above 30% after 2018; and
- Free operating cash flow (FOCF) to debt above 15%.

### Liquidity

We assess Emgesa's liquidity as adequate. We expect consolidated liquidity sources 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 declines by 15%. The company can also retain discretionary cash by reducing its large dividends. In addition, Emgesa isn't subject to financial covenants on its outstanding bonds as long as it is rated in the investment grade category.

Principal liquidity sources:
- Cash balance and short-term investments of COP103 billion as of June 30, 2017; and
- FFO of about COP1.2 trillion.

Principal liquidity uses:
- Short-term debt of about COP209 billion as of June 30, 2017;
- Maintenance capex of about COP160 billion; and
- Flexible dividend payout.

## Outlook

The stable outlook on Emgesa reflects our expectation that the company will remain a core subsidiary to Enel Americas and that the parent will support it in case of sovereign stress. It also reflects our view that Emgesa will continue to post debt to EBITDA below 2.0x and FFO to debt above 30% over the next few years.

### Downside scenario

We could lower our ratings on Emgesa upon a downgrade of its parent. We could revise Emgesa's SACP downward if its financial risk profile deteriorates, due to, for example, a more aggressive commercial strategy in the midst of worse hydrology conditions or a more aggressive expansion plan, leading to a debt-to-EBITDA ratio of more than 3.0x and FFO to debt of less than 30% consistently in 2017 and 2018.

### Upside scenario

A positive rating action on Enel Americas could lead to a similar action on Emgesa. Additionally, a consistent improvement in Emgesa's financial ratio, with debt to EBITDA below 1.5x and FFO to debt above 45%, could lead to an upgrade.

## Ratings Score Snapshot

Corporate credit rating: BBB/Stable/--

Business risk: Satisfactory
- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

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

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Ratings Affirmed

| | |
|---|---|
| Emgesa S.A. E.S.P. | |
| Senior Unsecured | BBB |



1908995 | 301477611

Ratings Affirmed; CreditWatch/Outlook Action

| | To | From |
|---|---|---|
| Emgesa S.A. E.S.P. | | |
| Corporate Credit Rating | BBB/Stable/-- | BBB/Negative/-- |