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Research Update:

Engie's Proposed Senior Unsecured Notes Of Up To $400M Rated 'BBB', Existing Ratings Affirmed, Outlook Remains Stable

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Rating Action Overview

- Chilean power-generation company, Engie Energia Chile S.A. (Engie), is planning to issue up to $400 million in senior unsecured notes due 2030. The company will use the proceeds to cancel the $400 million senior debt due 2021.
- On Jan. 15, 2020, S&P Global Ratings assigned its 'BBB' long-term rating to the proposed senior unsecured notes. At the same time, we affirmed our existing our 'BBB' issuer credit and senior debt ratings on Engie.
- The stable outlook reflects our expectations that the company will maintain a market share of 7%-8% in the following years and that there won't be early termination of its contracts that could jeopardize the stability and predictability of Engie's cash flows. In addition, the outlook incorporates our expectation that the company will develop its asset rotation strategy to increase non-conventional renewable capacity by 1 gigawatts (GW) with no significant deviations from the plan.

Rating Action Rationale

The shift to clean energy mix continues to move forward and, so far, its execution has been on time and within budget. The Chilean energy sector is rapidly transitioning to renewable sources from conventional thermal energy. Electricity from renewable energy sources represented just a small percentage of Chile's power generation a few years ago. However, non-conventional renewable energy has risen to about 20%, and we expect the growth to continue. Chile has set a target of 70% of electricity from clean energy sources by 2030.

In this context, Engie plans to replace fossil fuel sources with up to 1 GW in renewable energy in the next five years. As part of this strategy, Engie acquired the Los Loros and Andacollo solar parks with installed capacity of 55 megawatts (MW) for $35 million, which the company financed with its own cash flows. In addition, it is developing three new projects with planned completion in the next two years--the Tamaya (100 MW) and Capricornio (95 MW) solar parks, and the 150 MW Calama wind farm--which will cost approximately $300 million. Afterwards, the company will develop additional 600 MW of renewable energy capacity, subject to the closing of power purchase agreements (PPAs) with attractive margins. As part of the same strategy, Engie already shut down 170 MW of coal-based plants and committed to decommission additional 268 MW by the end of 2021 and 334 MW in 2024.

We consider the development of new capacity will prevent potential challenges in re-contracting Engie's existing PPAs, because customers are increasingly preferring cleaner energy sources.

PPAs' price indexation is in line with the renewables strategy. Engie's main strength includes PPAs with an average term of 12 years, which generate about 90% of total revenue, and a sale pricing mechanism to pass through fuel costs to customers at least until 2021. With the gradual retirement of coal plants, the company is also shifting the price indexation to the Consumer Price Index (CPI) from coal prices, which will reduce energy prices for its clients and diminish their carbon footprint. Replacement of carbon-based plants by renewable assets will be completed in the next three to four years. In our view, an increase in the company's renewable capacity will protect its cash flows against potential carbon tax increases in Chile, given that once the price indexation changes are completed, Engie will be unable to pass through potential coal price or carbon tax increases as it currently does.

So far, Engie has renegotiated about 25% of its contracts with the following offtakers: Corporacion Nacional del Cobre de Chile (A+/Negative/--), Freeport McMoRan Inc. (BB/Stable/--), Glencore plc (BBB+/Stable/A-2), and the Antucoya mine controlled by Antofagasta Minerals S.A. (not rated), all of which represent an aggregate annual consumption of approximately 3.3 terawatts per hour. We consider that Engie will successfully continue with its re-contracting strategy in the next few years.

If Engie doesn't continue its asset rotation plan, its competitive position could weaken. Engie is currently replacing part of its coal-based capacity for renewables, while its direct competitors, such as Colbun S.A. (BBB/Stable/--), and Enel Americas S.A. (BBB/Stable/--) are increasing their capacity. As a result, Engie's market share will slip to 7%-8% in 2025 from 9% currently, in terms of installed capacity of the SEN, Chile's power grid that supplies 98.5% of the country's total energy demand. Moreover, Engie has traditionally operated in the northern area of the country with a market share of approximately 34%. However, the grid in that part of the country has been connected with the central one in 2017, so competition has increased. In our view, delays in the company's decarbonization strategy and a further loss of market share represent risks for Engie, which we will continue to monitor.

The current leverage level will allow Engie to make investments. The asset rotation plan could require additional debt for approximately $300 million in the following years, which in our view, wouldn't significantly pressure credit metrics. Our base-case scenario assumes that Engie will generate EBITDA of $400 million - $450 million with an EBITDA margin above 30% in the next two years, reaching debt to EBITDA of 2.0x-2.5x. Therefore, the company still has cushion in its credit metrics, given that the trigger for a negative rating action would be a net debt to EBITDA in the 3.0x area.

Debt refinancing won't affect Engie's credit quality. In our view, the company is taking advantage of favorable market conditions to extend the tenor of its debt through the proposed senior unsecured bullet notes issuance. Engie will use the proceeds to repay the $400 million aggregate principal on the notes due 2021. In addition, the company will use any of the remaining proceeds for general corporate purposes, including working capital needs of its subsidiaries.

Outlook

The stable outlook reflects our expectations that the company will maintain a market share of 7%-8% in the next few years and that there won't be early termination of its contracts that could jeopardize the stability and predictability of Engie's cash flows. In addition, the outlook incorporates our expectations that the company will develop its asset rotation plan with no significant deviation that could hurt its transition to a renewable matrix. Therefore, we expect Engie to post robust credit metrics with debt to EBITDA below 3.0x, EBITDA of about $450 million, and EBITDA margin of 30% despite new investments.

Downside scenario

We could revise our outlook to negative or even lower the ratings in the next two years if contracts are terminated prior to their maturities or if the company struggles to re-contract its existing capacity, which may jeopardize its competitive position and profitability. A negative rating action is also possible if Engie's market share, in terms of installed capacity, falls below 7%. In addition, if the company takes on additional debt of more than $1.45 billion to expand renewables capacity, debt to EBITDA would rise above the 3.0x area starting in 2020 possibly triggering a negative rating action.

Upside scenario

We could raise the ratings on Engie if it maintains net debt to EBITDA below 2x, which we view as unlikely in the short to medium term due to the sizable investment plan.

Company Description

Engie is one of the leading electric power generators in Chile, with a 9% market share. It's the fourth-largest player after Enel Americas (25%), AES Gener (14%), and Colbun (13%). Engie has 2,204 MW of installed capacity as of Sept. 30, 2019, 60% of which comes from coal-based plants, 29% from gas-based plants, and the rest comes from renewables and oil/diesel plants. The company also owns the following assets:

- 2,293 kilometers (km) of high voltage and medium voltage of transmission lines, along with its 50% stake in Transmisora Eléctrica del Norte (TEN); and
- The Tocopilla and Andino ports.

Engie is a subsidiary of ENGIE SA, which owns 52.77% of the company. The remainder is owned by non-controlling minority shareholders floating in the stock market. We consider Engie as important to the group's long-term strategy, particularly for the expansion of its operations in Latin America, and the subsidiary is likely to receive support if necessary. Therefore, we view Engie as a moderately strategic subsidiary. As a result, we add one notch of uplift to the rating on Engie.

Our Base-Case Scenario

- Engie's exposure to a correlation between GDP growth and electricity demand impacts over spot revenues as also over take and pay contracts that represent around the 76% of contracted revenues, given that volumes could vary in case of lower demand. We further factor in inflation's effect on cost trends over time (please see our last publication on Latin America, "Political Challenges Will Prevail In 2020," Dec. 3, 2019). Our forecast for Chile's GDP growth is 2.4% in 2020, 2.9% in 2021, and 3% afterwards. We expect inflation at 2.9% in 2020 and to be in the 3% area afterwards.
- Power generation in a range of 6,000 and 7,000 gigawatt hours (GWh). In addition, given that spot prices are currently low, Engie is likely to continue buying about 6,000 GWh in the open market.
- Engie sells most of the energy through its contracts with regulated and unregulated customers. We expect average realized monomic (energy plus capacity) prices to be about $90 per megawatt hour (MWh) and $120 per MWh for unregulated and regulated clients, respectively.
- Other revenue consists of $4 million from spot market, gas sales in the $50 million area, and transmission revenue and ancillary services close to $150 million.
- Working capital outflows between $90 million and $100 million in 2020 due to the frozen tariff in 2019. We expect the company will gradually recover its working capital starting in 2021.
- Capital expenditures (capex), financed through cash flows and debt, of about $250 million in 2020 and $280 million in 2021. These investments include maintenance capex of about $60 million in 2020 and $30 million in 2021.
- No delays or cost overruns associated with the construction of the current projects.
- Dividend payout at 60% in 2020 and a 100% afterwards.

Liquidity

Our assessment of Engie's liquidity as adequate reflects our view that it will cover the liquidity needs for the next 12 months even if EBITDA declines by 15%, and that liquidity sources will exceed uses by more than 1.7x. However, if Engie develops the full 1 GW in the next few years, the ratio will likely to fall to the 1.2x area. Moreover, we factor the following qualitative aspects in our analysis:

- No restrictions stemming from financial covenants, because existing debt has only minor conditions related to the presentation of financial statements, which we don't expect cause difficulties for the company;
- Solid financial flexibility and easy access to credit markets, as seen in the pool of loans and bonds currently in Engie's portfolio and in the credit facilities;
- Generally good standing in the credit markets, as seen in the current trading of the company's bonds at or above par; and
- A generally prudent risk management, underscoring the historically low leverage.

Principal liquidity sources:

- As of Sept., 30, 2019, $177 million in cash and liquid investments; and

- Expected FFO in a range of $300 million and $350 million.

Principal liquidity uses:

- Capex of close to $250 million in the next 12 months, which the company can lower to $100 million in a financial distress scenario;
- Working capital outflows of about $80 million; and
- Dividends of approximately $70 million, at a 30% payout ratio over net income which is the minimum required by law.

Covenants

The existing debt doesn't have financial covenants, only reporting requirements (including the presentation of financial statements).

Environmental, Social, And Governance

In our view, Engie is more exposed to environmental risks than other energy conglomerates that began their power conversion process earlier, amid not only regulatory requirement but also amid the increasing demand for clean sources. As of this report's date, 60% of Engie's current installed capacity comes from coal-fired assets. Nevertheless, Engie has embarked on converting part of its energy mix into renewables. It mainly consists of the gradual decommissioning of coal plants reducing the share of the coal-based capacity to 20%, and expanding the solar and wind capacity to up to 1GW or 40% of total installed capacity. So far, Engie's conversion strategy has been on time and within budget, and we expect it to continue doing so in the short to medium term.

Issue Ratings - Subordination Risk Analysis

We don't see any material structural subordination risk on the senior unsecured debt instruments issued by Engie and rate them 'BBB', in line with the issuer credit rating on the company.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

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

Stand-alone credit profile: bbb-

- Group credit profile: a-
- Entity status within group: Moderately strategic (+1 notch from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment 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, 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

Ratings List

New Rating	
Engie Energia Chile S. A.	
Senior Unsecured	BBB
Ratings Affirmed	
Engie Energia Chile S. A.	
Issuer Credit Rating	BBB/Stable/--
Senior Unsecured	BBB