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Research Update:

Engie Energia Chile S.A. 'BBB' Ratings Affirmed, Outlook Remains Stable

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Table Of Contents

Research Update:

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Overview

- We expect Chile-based power generator Engie Energia Chile to maintain its prudent financial strategy and robust operating performance.
- We're affirming our 'BBB' ratings on the company and on its senior unsecured notes.
- The stable outlook reflects our expectations that Engie Chile will generate EBITDA of about $350 million in 2018, thanks to its strong contracted nature, and approaching $450 million afterwards due to the ramp-up of the PPAs with distribution companies and the entrance into operations of the new coal fired plant by the end of 2018. The outlook also reflects our expectation that debt to EBITDA won't exceed 3x in the next two years.

Rating Action

On July 30, 2018, S&P Global Ratings affirmed its 'BBB' ratings on Engie Energia Chile S.A. and on its senior unsecured bonds. The outlook remains stable.

Rationale

The affirmation reflects our expectation that Engie Energia Chile will continue to benefit from its long-term power purchase agreements (PPAs) with solid counterparties with an average remaining life of 13 years as of March 2018, which reduce cash flow volatility. The PPAs are with regulated customers (mainly the distribution companies) and large users (mainly industrial and mining companies such as Corporación Nacional del Cobre de Chile, Freeport-McMoRan Inc., Antofagasta Plc, and Glencore Plc). In addition, the contracts include a sale pricing mechanism that allows Engie Energia Chile to pass through fuel costs to its customers at least until 2021. We expect the power plants' operating availability to remain robust in the next two years, because most of them are relatively new.

On the other hand, the rating also incorporates the competitive pressures from other large power generators, given that Engie Energia Chile has a 8% market share in the National Electric System measured in terms of installed capacity as of March 31, 2018. The company has traditionally operated in the northern area of the country (formerly the SING system) with a market share of 34%, but that grid has been recently connected with the central one, forming a nationwide electric system.

As we had expected, Engie Energia Chile will finalize the construction of its 375 megawatt (MW) coal-fired power plant (Infraestructura Electrica Mejillones [IEM]) during the fourth quarter of 2018. In addition, the company has signed 15-year PPAs with distribution companies at attractive prices of $128 per megawatt per hour (MWh) (energy plus capacity price). In our view, these factors will support an EBITDA growth to around $350 million in 2018 and $450 million in 2019 with an EBITDA margin ranging from 30% to 35%, in comparison with $290 million, and a margin of 26% in the 12 months ended March 31, 2018. This is despite Engie Energia Chile's recent renegotiations of certain contracts with unregulated clients at lower prices in exchange for longer tenors. At the same time, Engie Energia Chile will continue with its sizable investment plan that includes not only the investment in IEM but on energy transition to renewables. Specifically, the company aims to invest $1 billion in 2019-2023 to increase the share of renewable generation, while closing its less efficient generation units. Therefore, we expect Engie Energia Chile's net debt to EBITDA to remain below 3x, while its free operating cash flow generation will remainnegative.

Our base-case scenario assumes the following factors:

- A correlation between GDP growth and electricity demand in the spot market—Engie Energia Chile's exposure is limited because it's only 5% of the energy sold. We further factor in inflation's effect on cost trends over time. (please see our last publication on Latin America, "Credit Conditions Latin America: Domestic Politics And Increasing U.S. Protectionism Undermine Favorable Conditions," Jun 27, 2018). Our forecast for Chile's GDP growth is 2.0% in 2018, 2.4% in 2019, and 2.5% in 2020. We expect annual inflation of 3% during the three years.
- Power generation of about 6,000 gigawatt hours (GWh) in 2018 and 7,000 GWh in 2019, given the start-up of IEM and the new PPAs. In addition, given that spot prices are low, Engie Energia Chile is likely to continue buying energy in the open market in a range of 4,000-4,500 GWh.
- Engie Energia Chile sells most of the energy through contracts: although the contracts with unregulated clients account for 60% of the total in 2018, we expect this percentage to decrease to around 50% as new PPAs with regulated clients start. We expect monomic prices to be around $90 per MWh and $120 per MWh for unregulated and regulated clients, respectively.
- Annual capital expenditures (capex) of around $350 million in the next three years. The company will finance them with a combination of internal cash generation and debt, which will cause debt to increase to around $1 billion from $842 million as of March 31, 2018.
- No delays or costs overruns associated with the construction of the ongoing projects.
- Dividend payout at 30%--a minimum legal requirement.

Group influence

We view Engie Energia Chile as a moderately strategic subsidiary for its parent, ENGIE SA (A-/Stable/A-2), which owns 52.77% of the company. Engie Energia Chile is a profitable business that we believe is important to the group's long- term strategy, particularly for the expansion of the latter's operations in Latin America, and which is likely to receive support if necessary. ENGIE's capital injections into Engie Energia Chile in the past years also back this assessment. As a result, we add one notch of uplift to the rating on Engie Energia Chile.

Liquidity

We assess Engie Energia Chile's liquidity as adequate because we expect its sources over uses of cash to be around 2x, considering that the company has flexibility to lower its capital expenditures if required. If the company performs all the investments –as expected under our base case scenario- the ratio will likely fall to 1.2x. Moreover, we continue to expect cash surpluses, even if the EBITDA generation declines by 15%. Additional qualitative aspects factored in our analysis include:

- No restrictions stemming from financial covenants because existing debt has only minor conditions related to the presentation of financial statements that we don't expect will represent a conflict for the company;
- The company has solid financial flexibility and easy access to credit markets, as seen in the pool of loans and bonds currently in its portfolio and in the committed and uncommitted credit facilities;
- Generally good standing in the credit markets, as seen in the current trading of its bonds at or above par; and
- A generally prudent risk management, underscoring the historically low leverage.

Principal liquidity sources for the next 12 months include:

- Cash and liquid investments of $59 million as of March 31 2018;
- Available committed lines of $200 million consisting of a revolving facility due June 2020; and
- FFO approaching $300 million in the next 12 months.

Principal liquidity uses in the next 12 months:

- Short term debt maturities of $110 million;
- Working capital outflows lower than $20 million;
- Total capex of $350 million in the next 12 months –that the company can lower to $100 million in a financial distress scenario; and
- Dividends of approximately $50 million, at a 30% payout ratio over net income.

Outlook

The stable outlook reflects our expectations that Engie Energia Chile will generate an EBITDA of about $350 million in 2018, backed by its strong contracted nature, trending up to $450 million thereafter due to the ramp-up of the PPAs with distribution companies and the entrance into operations of the new coal fired plant IEM by the end of 2018. The outlook also reflects our expectation that debt to EBITDA would not exceed 3x in the next two years.

Downside scenario

We could downgrade the company if its EBITDA plummets and/or debt increases beyond our expectations due to, for example, higher construction costs of ongoing projects or a more aggressive expansion strategy that demands extra funding, raising debt to EBITDA above 4x on a consistent manner. In addition, if we perceive the importance of the subsidiary to its controlling shareholder as less strategic (that could occur for example if there is an intention to sell a significant portion of its stake) or if its rating is downgraded to at least 'BBB', we could downgrade Engie Energia Chile by one notch.

Upside scenario

An upgrade will require an improvement in the company's net debt to EBITDA to around 2x, which we see as unlikely in the short to medium term due to Engie Energia Chile's current sizable investment plan. In addition, we don't see any upside from a business perspective given the company's relatively lack of diversification, in terms of business and geography, in comparison with larger peers.

Ratings Score Snapshot

Corporate 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)

- 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: A-/Stable
Status within group: Moderately strategic (+1 notch)

Related Criteria

- 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: Ratios And Adjustments, Nov. 19, 2013
- 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: Group Rating Methodology, 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

Ratings List

Ratings Affirmed

Engie Energia Chile S. A.	
Issuer Credit Rating	BBB/Stable/--
Analytical Factors	
Local Currency	bbb-

Engie Energia Chile S. A.

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