FitchRatings

Fitch Downgrades AES Panama to 'BB+'; Outlook Revised to Negative

Ratings Endorsement Policy
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Fitch Ratings-New York-30 April 2014: Fitch Ratings has downgraded AES Panama S.A.'s (AES Panama) foreign and local currency Issuer Default Ratings (IDRs) to 'BB+' from 'BBB-' The company's USD300 million notes due in 2016 were also downgraded to 'BB+'. The Rating Outlook has been revised to Negative from Stable.

The rating downgrades reflect the increased volatility in cash flows evidenced during recent years, coupled with a weakening operating environment due to energy transmission problems in the country and the potential for debt increases in the short term to finance capital expenditures. The Negative Outlook reflects ongoing hydrological problems in the country as well as continued transmission constraints in the short term.

AES Panama's ratings are based on the company's strong portfolio of assets with a competitive dispatch position, its multiple power purchase agreements (PPAs), as well as its adequate historical financial profile and no foreign-exchange risk. The ratings also reflect the company's exposure to hydrology risk given its elevated contracted capacity, regulatory intervention, and potential for long-term competitive price pressures.

KEY RATING DRIVERS

Deteriorating Credit Metrics:
During recent years, AES Panama's financial profile has been weakening as the company's cash flow generation has exhibited increased volatility. Cash flow generation has the potential to deteriorate further over the next two years should hydrology remain low. In 2013, the company's credit metrics weakened as result of non-planned purchases of energy in the spot market to fulfill obligations derived from its PPAs. The net impact of these transactions on year's operating cash was approximately USD117 million. EBITDA declined to USD57 million in 2013 from USD77 million in 2012, while leverage increased to 5.3x from 3.9x in the same period.

AES Panama's results could deteriorate in the short-term due to the ongoing drought in Panama and the possibility of another year of abnormally low hydrology during 2015. To mitigate the impact of these adverse hydrological conditions, the company is working to rebalance its generation portfolio and to reduce its contractual structure. The company is negotiating a PPA to sell capacity and energy from a 72MW (megawatt) power barge, which the company expects to start operating in early 2015. AES Panama expects this plant will add between USD37 million and USD50 million per year to the EBITDA in the next five years. As per the agreement with the Ministry of Finance, the company also expects to receive compensation for future purchases in the spot market for up to USD40 million in 2014 and up to USD30 million in the next two years. These actions could help the company to return to its historical levels of leverage by 2016, if current financial policies remain unchanged.

Cash Flow Supported by Contractual Position:
AES Panama's ratings reflect company's contractual position with low counterparty risk. Generation companies in Panama are permitted to enter into PPAs for up to their firm capacity allocation. The regulations promote the use of PPAs by requiring distribution companies to secure 100% of their peak regulated demand for the following year. AES Panama maintains PPAs for approximately 90%, on average, of available capacity through 2018 and 73% thereafter and until 2030. The company sells electricity under separate PPAs with the country's three distribution companies, Empresa de Distribucion Electrica Metro-Oeste S.A. (Edemet), Elektra Noreste (Fitch IDR of 'BBB'), and Empresa de Distribucion Electrica Chiriqui (Edechi), with various maturities. Panamanian distribution companies appear to have the sufficient credit quality and financial ability to support their respective obligations under the PPAs with AES Panama.

AES Panama benefits from a competitive portfolio of low-cost hydroelectric generating assets, including dam-based reservoirs and run of the river units. The diverse location of the company's assets somewhat mitigates its exposure to hydrology risk as the plants are located in different hydrology regions. AES Panama is the largest generation company in the country based on installed capacity. The company is composed of four hydroelectric plants throughout the country with a total installed capacity of approximately 482 MW and different dispatch priorities. The Bayano plant (260MW) operates during the peak load hours ahead of the more expensive thermal units. La Estrella (48MW) and Los Valles (54MW) are run of the river facilities and the first units to be dispatched in the system. Esti (120MW) is normally dispatched similar to run of the river facilities given the limited size of its reservoir.

Weakening Liquidity and No Foreign Exchange Risk:
The company's liquidity position has been affected during recent years as a result of weaker cash flow generation from operations and the company's continued dividend payment policy. The amortization schedule has been manageable with the only debt amortization coming due towards the end of 2016. Cash on hand as of Dec. 31, 2013 was approximately USD27 million, additionally the issuer maintained restricted cash for approximately USD10 million in the Debt Service Reserve Account. The company's financial policy is to maintain a minimum cash balance of USD20 million. The ratings of AES Panama are not constrained by the sovereign rating of Panama, as access to foreign exchange is not limited by finite foreign-exchange reserves or controls. Panama's track record of using the U.S. dollar and allowing private-sector debt repayment during periods of sovereign default allows entities in Panama to be rated above the 'BBB' sovereign rating and up to a country ceiling of 'A', based on the underlying corporate credit rating of the entity.

Exposure to Regulatory Risk:
The company's ratings also reflect its exposure to regulatory risk. Historically, generation companies in Panama were competitive unregulated businesses free to implement their own commercial strategies. In the past years, the increase in electricity prices has resulted in increased government intervention in the sector in order to curb the impact of high energy prices for end-users.

Exposure to Hydrological risk
The company maintains PPAs that represent approximately 92% of its firm capacity for 2014 (93% in 2013). According to the local regulator, firm capacity is calculated based on a 30-year historical average. This elevated level exposes AES Panama to changes in hydrological conditions such as those observed in 2013 and 2014. In 2013 spot prices increased to USD224/MWh from USD205/MWh given the ongoing drought. In first quarter 2014 spot prices reached USD287/MWh as hydrological conditions worsened. Prices considered in PPAs with distribution companies, the company's largest clients, are below USD100/MWh.

Currently, AES Panama's operations are being pressured by delays in expanding the country's transmission infrastructure. This has further exposed the company to purchases in the spot market and has triggered the government to issue a resolution to mitigate this risk for the affected generation companies. The Panamanian government agreed to compensate the issuer for future purchases in the spot market; this agreement synthetically reduces the company's contracted capacity by approximately 70MW or to 77% of its firm capacity for 2014. These compensations have a cap of USD40 million in 2014, USD30 million in 2015 and USD30 million in 2016.

RATING SENSITIVITIES
A downgrade could result from a combination of the following factors: leverage above 4.0x on a sustained basis, increased government intervention in the sector coupled with weakening regulatory framework, inability to reduce exposure to the spot market, and/or payment of dividends coupled with high leverage levels.

Factors that could trigger a positive rating action include: a sustained decrease in leverage below 3.0x coupled with an effective diversification of revenues among different fuels, and reduced exposure to the spot market.

Contact:
Primary Analyst
Giancarlo Rubio
Associate Director
+1-212-612-7899

Secondary Analyst
Vanessa Villalobos
Associate Director
+506-2296-9182

Committee Chairperson
Managing Director
Daniel R. Kastholm, CFA
+1-312-368-2070

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'

Applicable Criteria and Related Research:
--'Corporate Rating Methodology' (Aug. 5, 2013).

Applicable Criteria and Related Research:
Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage

Additional Disclosure
Solicitation Status