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## Research Update:

# AES Panama Downgraded To 'BB-' From 'BB+' On Weaker Financial Risk Profile; Outlook Negative

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## Research Update:

# AES Panama Downgraded To 'BB-' From 'BB+' On Weaker Financial Risk Profile; Outlook Negative

## Overview

- Panama-based hydropower generation company AES Panama's cash flow generation and liquidity has continued to weaken during the past two quarters because the persistent drought has forced the company to purchase power in the spot market to meet its high level of power sale contracts.
- We have lowered the corporate credit rating on AES Panama to 'BB-' from 'BB+', and revised its stand-alone credit profile (SACP) to 'b+' from 'bb'.
- We are removing the ratings from CreditWatch with negative implications, where we placed them on May 16, 2014.
- The negative outlook reflects our expectation that AES Panama's adjusted funds from operations (FFO)-to-debt and adjusted debt to EBITDA will be extraordinarily weak in 2014. FFO to debt will be negative and adjusted debt to EBITDA will be 15.0x-20.0x. We expect these ratios to improve to still weak levels of about 10% and 4x-5x, respectively, in 2015, assuming rain levels in Panama return to normal levels.

## Rating Action

On July 17, 2014, Standard & Poor's Ratings Services lowered its corporate credit rating and the rating on AES Panama S.A.'s outstanding \$300 million notes due 2016 to 'BB-' from 'BB+'. At the same time, we revised the company's SACP to 'b+' from 'bb'. We also removed the ratings from CreditWatch with negative implications, where we placed them on May 16, 2014. The outlook on the corporate credit rating is negative.

## Rationale

Our ratings on AES Panama reflect our assessment of its 'b+' SACP. The SACP is based on the company's "fair" business risk profile and "aggressive" financial risk profile as our criteria define these terms. It also reflects the company's "less than adequate" liquidity.

The rating on AES Panama incorporates our view that there is a "moderately high" likelihood that the government of Panama would provide timely and sufficient extraordinary support to AES Panama in the event of financial distress. In accordance with our criteria for government-related entities, our view is based on our assessment of AES Panama's role as the largest low-cost power generator in Panama and its strong link to the government, which has a

majority stake (50.5%) in the company. The AES Corp. (BB-/Stable/--) holds 49% and AES Panama's employees hold the remaining 0.5%.

We placed AES Panama on CreditWatch negative due to its weaker-than-expected year-end 2013 financial ratios, and our expectation that the likely El Niño phenomenon will further lower rainfall levels in the region during 2014 and 2015, which will weaken EBITDA generation.

AES Panama's adjusted net debt to EBITDA reached an extraordinarily weak level of 15.5x in the last 12 months as of March 31, 2014, and FFO to adjusted debt was negative 2.5%, which was considerably weaker than expected. The extremely weak hydrology in Panama debilitated AES Panama's exclusively hydropower generation. Total power generation was 465 gigawatt hours (GWh) from January to April, compared with 823 GWh contracted.

AES Panama's high contracted electricity output levels in its power sale contracts (93% of its 482 megawatt [MW] firm capacity for 2014 and 91% for 2015 considering AES Changuinola's 175 MW capacity) make it highly vulnerable to hydrological risk. In the first three months of 2014, AES Panama was forced to purchase about 263 GWh in the spot market to fulfill its power sale contracts, which led to a drop in gross profit margins to 17% in the 12 months ended March 31, 2014, compared with 52% in the same period of 2012. This trend will likely continue through the end of the year and throughout the first quarter of 2015 due to the high likelihood of an El Niño event during the fall, which tends to reduce rainfall across the region.

We have revised AES Panama's financial risk profile to "aggressive" reflecting our expectation for weak cash flow generation during 2014, which would result in an annual adjusted EBITDA of only about \$20 million (compared with the \$108 million average of the past five years) and weak financial metrics. In our base-case scenario, we assume a weak to moderate El Niño developing in October and November and lasting through first quarter 2015. However, we expect the company's metrics to improve relatively rapidly afterward once hydrology normalizes. Moreover, we expect AES Panama to announce its investment in a fuel oil barge with a total installed capacity of 72 MW and power sale contracts with local electric distribution company, EGESA, which should improve earnings. We expect this new investment, which would be fully financed with bank debt, to start generating \$40 million - \$50 million in EBITDA in 2015 and help reduce AES Panama's cash flow volatility in the next 12-18 months.

AES Panama is struggling with extraordinarily low hydrology, significantly low power generation of its fully hydro capacity, high power sale contracts, and skyrocketing spot electricity prices. In the past 12 months, lower-than-historic average rainfall has resulted in spot prices of more than \$280 per megawatt hour (MWh) compared with AES Panama's average contracted sale price of about \$87/MWh (considering capacity charges). Spot prices have remained very high in Panama during the first six months of 2014, compelling the government to implement strategies to avoid electricity shortages. On March 31, 2014, the company reached an agreement with the Ministry of Finance

that compensates AES Panama for the government's delay in investment in the country's third transmission line. The government decided to reimburse the high cost of AES Panama's purchases in the spot market for up to \$40 million in 2014 and \$30 million in 2015 and 2016, each. This compensation will partly offset the high cost of its purchases in the spot market resembling a hedge on the spot market for 70 MW up to these amounts.

We adjust our debt figures to include the present value of the future stream of capacity payments under AES Panama's and AES Changuinola's power purchase agreement (PPA). The adjustment pushes up debt to \$109.9 million with a depreciation adjustment of \$3.1 million and an interest equivalent of \$7.1 million.

AES Panama owns and operates four hydroelectric plants totaling 482 MW of installed capacity. In addition, AES Panama has a PPA with hydropower generator, AES Changuinola, from which it buys 175 MW or 100% of the generator's firm capacity until 2030 at a fixed price. The AES Corp. holds a majority stake in AES Changuinola.

## **Liquidity**

We view AES Panama's liquidity as "less than adequate," as defined under our criteria. In our view, the company's liquidity sources will barely be sufficient to cover its uses for the next 12 months.

Principal liquidity sources:

- Cash and short-term investments for \$48.3 million as of March 31, 2014;
- Positive FFO of about \$30 million (including a \$40 million compensation from the national government); and
- Committed bank financing of \$57 million for the barge purchase.

Principal liquidity uses:

- Bank debt maturities for \$50 million;
- Working capital requirements for about \$15 million; and
- Capital expenditures (capex) for about \$62 million mainly for the barge's acquisition.

## **Outlook**

The negative outlook reflects our expectation that AES Panama's adjusted FFO to debt and adjusted debt to EBITDA will be extraordinarily weak in 2014. We expect FFO to debt to be negative and adjusted debt to EBITDA will be 15x-20x. We expect these ratios to improve but to still weak levels of about 10% and 4x-5x, respectively, in 2015, assuming rainfall in Panama returns to normal levels. Because AES Panama's is a government-related entity (GRE), we would have to revise its SACP downward more than one notch to trigger a downgrade on the company.

### Downside scenario

This could result from a prolonged below-average hydrology resulting in liquidity pressures or if the barge's financing falls through, which could significantly affect the company's financial condition.

### Upside scenario

An upgrade would require the company to strengthen significantly its cash flow generation, resulting in FFO to adjusted debt of more than 30% and adjusted debt to EBITDA below 3.0x through the cycle. This could occur if rainfall returns to normal in Panama in conjunction with the additional 72 MW from the acquired barge, allowing the company to reduce its total outstanding debt.

## Ratings Score Snapshot

Issuer Credit Rating: BB-/Negative/--

Business risk: Fair

- Country risk: Moderately High risk
- Industry risk: Moderately High risk
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than Adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b+

Related government rating: BBB

Likelihood of government support: Moderately high (+1 notch)

## Related Criteria And Research

### Related Criteria

- Key Credit Factors For The Unregulated Power and Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Rating Government-Related Entities: Methodology And

Assumptions, Dec. 9, 2010

## **Ratings List**

Downgraded; CreditWatch/Outlook Action

	To	From
AES Panama S. A.		
Corporate Credit Rating	BB-/Negative/--	BB+/Watch Neg/--
Senior Unsecured	BB-	BB+/Watch Neg

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