FITCH AFFIRMS AES PANAMA AT 'BBB-'; OUTLOOK REVISED TO POSITIVE

Fitch Ratings-New York-14 June 2018: Fitch Ratings has affirmed AES Panama SRL's (AESP) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Rating Outlook has been revised to Positive from Stable. Fitch has also affirmed AESP's National Scale rating at 'AA+(pan)'. The Rating Outlook remains Stable. In addition, AESP's senior unsecured noted ratings have been affirmed at 'BBB-' and 'AA+(pan)'.

The ratings reflect AES Panama's strategic changes to its generation portfolio and re-contracting strategy, underpinned by Panama's evolving electricity matrix designed to mitigate spot price volatility. Under normal hydrological conditions, Fitch expects leverage of 3.0x or lower through the rating horizon, supported by higher average energy prices under Power Purchase Agreements (PPAs).

KEY RATING DRIVERS

Mitigating Hydrological Risk: AESP maintains PPAs that represent approximately 90% of its installed capacity. This elevated level exposes AESP to changes in hydrological conditions and spot market prices, such as those observed during 2014 and 2013. To manage climatological risk, AESP added a 72MW thermal barge, Estrella del Mar, to its asset base. With contracts tied to fuel prices, the thermal barge serves as an effective hedge against spot price volatility through life of its PPA ending in 2020. Thereafter, assuming AESP does not sell it, the barge could function as back-up in the event of low hydrology.

The company's re-contracting strategy for the hydro generators will prove equally important. Currently, AESP intends to let its contracts expire over the next five years, whereupon it will try to enter into short-term contracts (giving the company a better degree of climatological visibility), reducing or increasing its contracted capacity as hydrology and spot price forecasts permit. With respect to the latter, Panama has nearly 1300 MW of non-hydro based generation under various stages of constructions between now and 2020, including a 380MW natural gas plant that will be operated by AES Corp. through a joint venture with Inversiones Bahia. The expansion of alternative generation sources within the Panamanian power matrix should help keep spot prices low, even in stressed hydrological conditions.

Improving credit Metrics: AES Panama's (AESP) credit metrics have seen sharp improvement since it experienced exceptionally weak hydrology in 2014. In 2017, AESP showed EBITDA of USD130 million on revenues of USD342 million (versus USD12 million and USD261.8 million, respectively in 2014). This was primarily driven by improved hydrological conditions and by cheaper spot prices. Moderate global oil and gas prices combined with an increasingly diverse energy matrix in Panama should keep spot price trends low. Consequently, the company's margins have recovered to 38% (vs. 5% in 2014), while leverage improved to 2.9x and interest coverage rebounded to 5.8x. As expected, Fitch has seen tighter liquidity as the company returns to its stated cash policy whereby excess funds over USD20 million are paid out as dividends.

Fitch expects leverage to remain at around 3.0x through the rating horizon, although a temporary spike in EBITDA in 2019 could drive leverage to 2.0x or lower. This is a result of major repairs to AES Changuinola's generation tunnel, which will take the unit off line for approximately 10 months in 2019. As a result, during the maintenance period, AESP will replace those generation purchases with energy from the spot market at prices significantly below those established under the Changuinola PPA.

Strong Market Position and High-Quality Offtakers: AES Panama's ratings reflect the 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. According to the local regulator, firm capacity is calculated based on a 30-year historical average. 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 90.5%, on average, of available capacity through 2018. 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 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 is the largest generation company in the country based on installed capacity accounting for 24% market share (without considering AES Changuinola installed capacity of 223MW). 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.

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. Efforts to diversify the country's energy matrix will help lower prices over the medium, reducing the need for regulatory interference.

DERIVATION SUMMARY

AESP's most appropriate peers are Isagen S.A. ESP (BBB/Stable) and Emsgesa, both Colombian generators with significant hydroelectric capacity. Consistent with their investment grade ratings, all three companies mitigate El Nino risk with back-up thermal capacity. They also benefit from regulatory environment that have evolved in the last several years to reduce potential price volatility from stressed hydrological conditions. With 547MW of installed capacity and a long term physical contract for 223MW with its sister company, AES Changuinola (A+(pan)/Watch Negative), AESP functionally represents 23% of the Panama's installed capacity. This is in line with peers, which have between 20% to 25% of their respective markets; however, in terms of gross capacity, Isagen and Emgesa each have installed capacity in excess of 3,000MW.

AESP's capital structure is broadly in line with Isagen, posting gross leverage of around 3.0x under normal hydrology conditions. Emgesa's gross leverage has remained below 3.0x historically and is expected to fall below 2.0x through the medium term. AESP's interest coverage is similar to Emgesa's at around 5.0x historically, while Isagen's interest hovers around 3.0x.

KEY ASSUMPTIONS

Fitch's key assumptions within its rating case for the issuer include:
--New, low cost capacity through next 5 years keeps spot prices low;
--Sharp increase in average monomial price in 2018, as new DisCo PPA's become active;
--No significant El Nino effects in the near to medium term;
--Excess cash above USD20 million paid out as dividends;
--Barge fuel costs track Fitch WTI forecast.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action:
--A sustained decrease in leverage below 3.0x;
--A conservative contracting strategy that continues promotes cashflow stability and withstand hydrological shock to the system;
--Continued evidence in the Panamanian market of sustainable spot price stabilization as a result of asset diversification in electricity matrix.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action:
--A downgrade could result from a combination of the following factors: leverage above 3.5x on a sustained basis;
--Increased government intervention in the sector coupled with weakening regulatory framework;
--Deterioration in the company's ability to mitigate spot market risk; and/or payment of dividends coupled with high leverage levels.

LIQUIDITY

AESP's policy is to maintain a cash balance of USD20 million, dividends payments are subordinated to this policy. The company maintains short-term credit facilities for up to USD 45 million (Scotiabank USD20 million, Banco General USD10 million, Banco Panama USD5 million, Banistmo USD5million, Bac International Bank USD5 million).

AESP benefits from a favorable debt maturity profile, with a USD300 million bond due 2022 as its sole debt obligation and approximately USD22 million of interest expense annually.

FULL LIST OF RATING ACTIONS

AES Panama SRL
--Long-term Foreign Currency IDR at 'BBB-'; Outlook to Positive from Stable;
--Long-term Local Currency IDR at 'BBB-', Outlook to Positive from Stable;
--Senior unsecured notes international rating at 'BBB-';
--Long-term National Scale rating affirmed at 'AA+(pan)'; Outlook Stable;
--Senior unsecured notes national scale rating at 'AA+(pan)'.

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Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023785
National Scale Ratings Criteria (pub. 07 Mar 2017)
https://www.fitchratings.com/site/re/895106
Parent and Subsidiary Rating Linkage (pub. 15 Feb 2018)
https://www.fitchratings.com/site/re/10019836
Sector Navigators (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023790