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Research Update:

AES Panama S.R.L. 'BB' Ratings Affirmed, Outlook Remains Negative

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Rating Action Overview

- Low rainfall levels, combined with higher exposure to the spot market, are pressuring AES Panama's credit metrics. The higher exposure to the spot market stems from the repair of its 175 megawatt (MW) hydro-based power plant, AES Changuinola.
- On April 5, 2019, S&P Global Ratings affirmed its 'BB' issuer credit and debt ratings on the Panama-based power generator.
- The outlook remains negative, which reflects the possibility of a downgrade in the next six months if hydrology conditions in Panama weaken further and/or if AES Changuinola's repair takes longer than expected, extending AES Panama's exposure to the spot market.

Rating Action Rationale

We expect lower cash flows for AES Panama, given that it will be exposed to the spot market because of the nine-month repair stoppage of AES Changuinola due to a leakage in its water tunnel. As a result, the plant will be unable to deliver the contracted energy to AES Panama, while the latter has a long-term power purchase agreement (PPA) contracts with the power distribution companies. Therefore, the company will need to buy energy from the spot market. Moreover, the rainfall level was record low in December 2018, and we expect low hydrology in the first half of 2019. This has caused dispatch of thermal plants, pushing spot market prices to around $110 per megawatt per hour (MWh); we expect them to increase until May and to fall below $100 per MWh until July, when the rainy season begins.

The 'BB' ratings continue to incorporate the company's competitive position as the largest power generator in Panama, offset by the historical volatility of profitability due to hydrological exposure. In addition, the ratings reflect our expectations that AES Panama's cash flow generation will remain in line with our expectations, with EBITDA margin of around 50% in the next three years. Moreover, ratings continue to incorporate our expectations of net debt to EBITDA below 5.0x and funds from operations (FFO) to debt around 13% for the next two years. Our base-case scenario assumes low hydrology in the first half of 2019 and normal hydrology afterwards, as well as no delays in AES Changuinola's repair. In our view, the company's thermal plants (including AES Colon) and the lower contract levels for the following years to around 80% mitigate the exposure to hydrology fluctuations.

AES Panama owns and operates four hydroelectric plants totaling 482 MW of installed capacity, a diesel-powered barge with 72 MW of installed capacity, as well as a thermal plant with 381 MW, AES Colon, which started operations in September 2018. In addition, AES Panama has a PPA with AES Changuinola, from which it buys 175 MW or 100% of the generator's firm capacity until 2030 at a fixed price.

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 PPAs. We believe long-term PPAs create fixed, debt-like financial obligations that substitute for debt-financed capital investments in generation capacity. We also consider operating leases and guarantees as debt-like obligations. The adjustment adds around $360 million to AES Panama's debt.

Our base-case scenario assumes the following factors:

- Economic variables that we view as relevant for the power generation business, particularly an increase in electricity demand in line with our forecasted GDP growth in Panama of about 5.5% in 2019 and 4.0% in 2020, in line with our credit conditions report (see "Credit Conditions Latin America: Dovish Fed Eases Short-Term Risks, But Political Challenges Persist,", published March 28, 2019).
- Average spot prices of around $100 per MWh in 2019 and $60 per MWh afterwards, based on our expectations of lower-than-usual hydrology conditions and average oil prices of $50 per barrel (bbl) in 2019 and 2020, according to our oil price deck (see "Brent Crude Price Assumption For 2019 And 2020 Raised To $60 Per Barrel," published March 18, 2019).
- Average contracted prices of around $110 per MWh in 2019 and 2020.
- Total energy sales of around 2,800 gigawatt hours (GWh) in 2019 and 2,700 GWh in 2020.
- Low maintenance capital expenditures (capex) for the next two years of around $7 million per year.
- A 100% dividend payout, leaving a minimum of $20 million for its operations.
- No additional debt.

Based on these assumptions, we arrive at the following credit metrics for 2019 and 2020:

- Adjusted EBITDA of around $160 million and a margin of 45% in 2019, and $165 million and 50% in 2020, respectively;
- Adjusted FFO to debt around 13%; and
- Adjusted debt to EBITDA of approximately 4.5x.

Our ratings also incorporate our view that there's a moderately high likelihood that the government of Panama (BBB/Positive/A-2) would provide timely and sufficient extraordinary support to the company in the event of financial distress. This stems from our assessment of AES Panama as the largest energy producer in the country, a low-cost power generator, 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%.

Outlook

The negative outlook on AES Panama reflects our view that there's at least a one-in-three chance of a downgrade in the next six months. This could occur if hydrology conditions in Panama weaken further, pushing up spot market prices, and the stoppage taking longer than expected. Exposure to market prices could pressure the company's credit metrics.

Downside scenario

We could lower the ratings if the company's debt to EBITDA rises above 5.0x and FFO to debt falls below 12% in the next months. This could happen if hydrology in Panama continues to weaken, pushing the annual average spot market prices above $125 per MWh during the stoppage of AES Changuinola, and/or if the latter takes longer than expected. These factors would extend AES Panama's exposure to the spot market because it needs to fulfill its commitments under the existing long-term PPAs. A downgrade could also occur if we revise our liquidity assessment on the company to a weaker category if sources over uses of cash fall below 1.2x. Furthermore, given that AES Panama is a government-related entity, a downgrade is also possible following a reassessment of our view of extraordinary support from the government.

Upside scenario

We could revise the outlook to stable if AES Panama demonstrates a conservative hydrology risk management plan, maintaining the expected cash flows at current levels with EBITDA margin relatively stable at around 50% in the next two years, while all other factors remain unchanged, in particular our view of liquidity and assessment of the government extraordinary support.

Liquidity

We assess AES Panama's liquidity as adequate. We expect liquidity sources to exceed uses by more than 1.2x in the next 12 months and that the company's sources over uses will remain positive even if our forecasted EBITDA declines by 15%. Moreover, we believe AES Panama has the flexibility to address short-term pressures given its low capex and general prudent risk management strategy, because the company has the flexibility to reduce dividend payments if operating performance is below expectations, as was the case in 2014.

Principal Liquidity Sources:

- Cash and short-term investments for about $16 million as of Dec. 31, 2018;

- FFO generation of about $82 million; and
- Working capital inflows of approximately $12 million in the next 12 month.

Principal Liquidity Uses:
- Debt maturities of $12 million as of Dec. 31, 2018;
- Capex for about $8 million; and
- Dividend payments of 100% of net income, which is about $70 million in the next 12 months.

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: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-
Related government rating: BBB
Likelihood of government support: Moderately high (+1 notch)

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

AES Panama S.R.L.	
Issuer Credit Rating	BB/Negative/--
Senior Unsecured	BB

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.