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Research Update:

Colbun S.A. 'BBB' Global Scale And 'clAA-/clA-1+' National Scale Ratings Affirmed, Outlook Remains Stable

Primary Credit Analyst:
Cecilia L Fullone, Buenos Aires (54) 11-4891-2170; cecilia.fullone@spglobal.com

Secondary Contact:
Candela Macchi, Buenos Aires (54)-11-4891-2110; candela.macchi@spglobal.com

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Overview

- We continue to expect that Chile-based power generator Colbun will maintain its solid credit metrics and robust operating performance.
- We're affirming our global scale corporate credit ratings at 'BBB' and our Chilean national scale ratings at 'clAA-/clA-1+'.
- At the same time, we're removing the outlook on Colbun's $500 million 4.5% notes due 2024, which was incorrectly assigned on May 29, 2017.
- The stable outlook reflects our expectations that Colbun will maintain its net debt to EBITDA at less than 3x and free operating cash flow (FOCF) at more than 20%.

Rating Action

On May 7, 2018, S&P Global Ratings affirmed its 'BBB' global scale and 'clAA-/clA-1+' Chilean national scale corporate credit ratings on Colbun S.A. The outlook remains stable.

Rationale

The ratings on Colbun continue to incorporate the company's market-leading position as the second-largest power generator in Chile (with a 23% market share in the Central Interconnected System after Enel Generacion Chile S.A., measured in terms of electricity generation in 2017). The ratings also reflect the company's large share of the Peruvian market where it accounted for 8% of the total generation in 2017. In addition, the company benefits from large offtake agreements with solid counterparties with an average tenor of 9.5 years in Chile and of six years in Peru that reduce cash flow generation volatility. Colbun sells power mainly through power purchase agreements (PPAs), rates for which are denominated in U.S. dollars and indexed to changes in fuel prices and U.S. inflation. These PPAs are with regulated customers (CGE Distribucion S.A., Enel Distribucion S.A., Saesa, Distriluz, and Luz del Sur and Calidda) and large users (mining companies such as Corporacion Nacional del Cobre and Angloamerican Sur S.A. and industrial companies). As of December 2017, Colbun's exposure to the spot market was marginal. We expect its power plants' operating availability to remain robust in the next two years (above 95% on average), because all of them are relatively new.

Given Colbun's diversified asset generation capacity of about 3,884 megawatts (MW), its prudent commercial strategy taking into account that approximately 42% of its capacity is hydro, and still dry-–although improving--hydrological conditions in Chile, we believe that EBITDA should range from $600 million to $650 million in the next two years, with a margin of 42%-45%. Our financial risk profile assessment on the company also incorporates certain volatility in cash flow generation, as it would depend--to certain extent--on weather conditions and electricity prices, which decreased sharply in the past 18 months due to the entrance of solar and wind technologies into the market, sluggish demand, and migration of certain regulated clients into free clients.

Our base-case scenario assumes the following factors in the next two years:

- Macroeconomic variables that we view as relevant for the unregulated utilities, particularly GDP growth, which mainly correlated to demand for electricity, and inflation levels that affect cost trends over time. For our analysis, we have used Chile's and Peru's macroeconomic data issued in the latest credit conditions article, "Latin America March 2018 - Political Risk May Dampen The Risk Of A Global Economic Upswing," published March 28, 2018. We expect Chile's GDP growth of 3.1% in 2018 and 3% in 2019, and 3.5% and 3.8%, respectively, in Peru. Inflation in Chile should be 2.8% in 2018 and 3.2% in 2019.
- Stable energy capacity, given that there are no large projects reaching commercial operations in the next two years.
- Our analysis incorporates still dry hydrologic conditions in Chile at a level of P80. That would lead to the company's total generation of around 12,500 gigawatts per hour (GWh) mostly to serve contracts. We expect average prices of $105/GWh for regulated clients, $80/GWh for unregulated clients, and $40/GWh for spot sales.
- In Peru, Colbun's average generation should approach 4,100 GWh, of which approximately 75% are sold under long-term PPAs with an average price of $47/GWh and the remainder to the spot market for $10/GWh.
- We consider cost increases in line with our projections for inflation levels in both countries.
- Capital expenditures of $110 million in 2018 and $75 million in 2019, most of which consist of maintenance levels.
- Non-committed acquisitions of $500 million in 2018 (given Colbun's stake in the new assets only and excluding any additional debt or EBITDA that the new project will contribute to Colbun's total).
- Dividend payments at 100% of the previous year's net income in 2018 and 50% afterwards.

Based on these factors, we expect to see the following credit metrics in the next two years:

- Net debt to EBITDA of around 2x;
- Funds from operations (FFO) to net debt of more than 30%; and

- FOCF to net debt of more than 20%.

The Chile-based company, Minera Valparaiso S.A., controls Colbun. Minera is a diversified conglomerate that operates mainly in the power generation, forest products, and real estate industries. In 2017, Colbun represented the vast majority of Minera's EBITDA and debt. We view Colbun as a core subsidiary of Minera. Therefore, we conclude that the ownership structure doesn't constitute a limitation to the rating on Colbun.

Liquidity

We assess Colbun's liquidity as strong. This reflects Colbun's sources over uses of cash that are higher than 1.5x while its sources less uses of cash will remain positive, even if forecast EBITDA declines by 30%. In addition, given Colbun has its debt maturities structured as long term--most of which mature in 2024--the company has ability to absorb high-impact, low-probability events. Finally, our analysis incorporates Colbun's sound relationships with banks, as seen in the pool of loans and bonds currently in its portfolio, the committed and uncommitted credit facilities, and satisfactory standing in credit markets.

Principal liquidity sources:

- Cash and liquid investments as of Dec. 31, 2017, of $811 million; and
- FFO approaching $450 million.

Principal liquidity uses:

- Short-term debt maturities of $59 million as of Dec. 31, 2017;
- Capital expenditures of about $80 million;
- Working capital outflows close to $100 million; and
- Dividends at 50% of the net income, although the company can lower it to 30% of the net income--the minimum legal requirement--in case of a financial stress.

Colbun has financial covenants related to its debt: total liabilities to equity of less than 1.2x, a minimum net worth of $1.3 million and EBITDA to net interest expenses of above 3.0x. As of Dec. 31, 2017, the company was in compliance with them, and in our view, it has sufficient headroom for forecasted EBITDA to decline by 50% without breaching the covenants tests.

Outlook

The stable outlook reflects our expectations that Colbun will maintain its balanced commercial strategy and will pursue growth through a transparent and well-managed financial discipline, allowing the company to keep its net debt to EBITDA at less than 3x and FOCF to debt of more than 20%.

Downside scenario

In the next two years, we could downgrade the company if we perceive a sustained increase in its leverage such that its net debt to EBITDA rises to above 3x and its FOCF to debt decreases to below 15%. Such metrics could result from EBITDA plummeting to $400 million - $450 million due to, for instance, worsening hydrological conditions or lower-than-expected prices. Moreover, the deterioration in the company's metrics could be the result of a debt increase beyond our expectations due to, for example, a more aggressive expansion strategy, particularly acquisitions.

Upside scenario

An upgrade of Colbun would require a significant improvement in the its credit metrics, particularly net debt to EBITDA below 1.5x and FOCF to debt above 40%.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/--
Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage Intermediate

Anchor: bbb
Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

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, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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

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.