Fitch Affirms Elektra Noreste at 'BBB'; Outlook Stable

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Fitch Ratings-New York-01 November 2019: Fitch Ratings has affirmed the Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) for Elektra Noreste S.A. (ENSA) at 'BBB'. The Rating Outlook is Stable. In addition, Fitch has affirmed the rating on the senior unsecured notes due 2021 at 'BBB'. ENSA's ratings are based on its strong financial position, stable cash flow generation and low business risk profile, which is characteristic of electricity distribution companies. Cash flow stability is positively incorporated into the rating as it lowers business risk and adds to certainty. The ratings also incorporate ENSA's exposure to regulatory risk, which is considered moderate.

KEY RATING DRIVERS

Solid Financial Structure: Elektra Noreste's solid financial structure supports its 'BBB' rating and is comparable with that of similarly-rated regional peers. Fitch expects the company's 2019 leverage to be 3.2x with a decline to below 3.0x over the rating horizon due to lower electricity purchase prices reducing the cost of energy losses, gradual electricity demand growth and inflation adjustments to its regulated energy margin. Fitch expects the company's FFO interest coverage to rise to above 5.0x in 2021 as a result of continued strong cash flow and lower interest costs as the company refinances its USD100 million 7.6% fixed coupon 2021 bond with lower-cost debt.

Lower Capex to Improve FCF: The 2H2018-1H2022 tariff requires ENSA to make capital expenditures of USD191 million over the four-year period. This represents a meaningful decrease from the USD271 million required during the previous tariff period from 2H2014 to 1H2018 when the country was growing more rapidly with real GDP growth regularly above 5%. Fitch expects the moderated capex requirements to improve the company's free cash flow from structurally negative to neutral and allow for leverage to fall below 3.0x over the rating horizon. The company's practice of paying the majority of its net income in dividends partially offsets the positive impact on FCF.

Lower Energy Costs Benefit Margins: Due to the current dry conditions and low hydrology in Panama, energy costs for ENSA's customers reached USD159/MWh in the first half of 2019. While these costs are largely passed through to end customers, Fitch estimates approximately 2% of the company's energy purchases are losses absorbed by ENSA. Due to spare capacity entering the generation system, particularly low-cost LNG plants, along with anticipated normalized hydrology conditions, Fitch assumes total energy costs will fall to approximately USD120/MWh by 2021, translating to an additional USD2.5 million in the company's EBITDA.

Low Business-Risk Profile: ENSA's credit profile is supported by its natural monopoly position. ENSA's concession area is exclusive and has well-defined boundaries, encompassing roughly half of the Panama City metro area and provinces to the north and east. While the less stable area of Colon is 16% of ENSA's demand, its user base is relatively densely populated with 38 users per kilometre of lines, making its concession area easier and more economical to manage. The concession is permanent, but the concession contract is reviewed every 15 years with the current contract expiring in October 2028.

Moderate Regulatory Risk: ENSA faces moderate regulatory risk associated with tariff adjustments, which can directly affect the company's cash flow generation. ENSA's distribution tariffs are based on a price-cap methodology with the value added from distribution (VAD) reset every four years. The current 2018-2022 tariff allows the company to charge users USD41.95/MWh above the cost of energy and this amount is adjusted semi-annually to reflect changes in the Panamanian consumer price index (CPI). Fitch considers this allowance reasonable for the company to meet its commercial and financial obligations. Tariffs are adjusted monthly to pass through fuel price changes.

Subsidy Reduction: In 2017, subsidy eligibility was tightened to those consuming 300 KWh/month or less from the previous level of 500 KWh. About 72% of ENSA's customers qualify for subsidies and in 2018 the company received USD65 million, equating to roughly 70% of EBITDA. Two thirds of the subsidy amount was considered additional due to rising fuel prices. In October 2019, the newly-elected government approved USD21.5 million for the country's Tariff Stabilization Fund for 1H2019, comparable to USD18.6 million in 2H2018. While important to ENSA's cash flow, subsidies are less critical than for regional peers and become more significant when fuel prices rise.

DERIVATION SUMMARY

With expected gross leverage of 3.2x in 2019, ENSA's rating and credit profile are in line with those of its peers in the region. Its closest rating peers are its parent company Empresas Publicas de Medellin (EPM) (BBB/Rating Watch Negative) and Grupo Energia Bogota (GEB) (BBB/Stable Outlook), which have expected 2019 leverage of 3.4x and 3.9x, respectively. Both GEB and EPM benefit from their much larger scale, with annual EBITDA many times that of ENSA. ENSA has a comparatively more stable cash flow, which is also reflected in a smoother leverage trajectory. Lower-rated peers include Energuate Trust (BB/Negative Outlook) and AES El Salvador Trust II (AES SLV) (B-/ Stable). Both DisCos are constrained by weaker capital structures and, in particular, exposure to weaker operating environments.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Its Rating Case for the Issuer
--Electricity demand growth linked to Fitch GDP forecast;
--Stable energy losses of approximately 11.5% during the rating horizon;
--Current tariff assumptions prevail in 2H2022;
--Long-term Spot Price of USD70/MWh, reflecting reduced costs due to new generation sources;
--Maturing debt is rolled over into similar instruments at market rates;
--Majority of previous year's net income is paid in dividends, maintaining a minimal cash balance.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

--With gross debt/EBITDA at or above 2.5x, ENSA has modest headroom in the 'BBB' category. Therefore, Fitch does not anticipate positive rating action in the near term.

Developments That May, Individually or Collectively, Lead to Negative Rating Action

--Weakening of gross leverage to 3.5x or above on a sustained basis combined with increased reliance on government subsidies;
--Tariff adjustments that significantly reduce cash flow generation;
--Increases in debt and/or dividend distribution; sovereign downgrades reflecting deterioration of macroeconomic conditions.

LIQUIDITY

Strong Liquidity: While Elektra Noreste has a USD100 million bond maturing in 2021 and USD17 million in short-term debt, the remainder of the company's financial obligations are staggered with a USD100 million loan from The Bank of Nova Scotia due 2023 and a USD80 million bond due 2027. Fitch expects the company to have strong operating cash flow over the rating horizon of between USD60 million and USD75 million. Additionally, the company had uncommitted credit lines totalling USD285 million from seven different financial institutions as of June 30, 2019. While the company's practice of paying the majority of its net income in dividends does affect free cash flow, Fitch expects capex requirements to be reduced over the rating horizon. As of June 30, 2019, Elektra Noreste had a cash balance of USD6.3 million.

ESG Considerations
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the

entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:
Elektra Noreste S.A.
--Long-Term Foreign Currency IDR at 'BBB'; Outlook Stable;
--Long-Term Local Currency IDR at 'BBB'; Outlook Stable;
--Senior unsecured debt rating at 'BBB'.

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Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

Additional Disclosures
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