Research Update:

Portuguese Electric Utility EDP 'BBB-/A-3' Ratings Affirmed On Improved Credit Metric Headroom; Outlook Stable

October 7, 2020

Rating Action Overview

- As part of its 2019-2022 strategic plan, EDP is focused on deleveraging, having already signed more than 70% of the €6 billion between disposals and asset rotation deals announced as part of its 2019-2022 strategic plan.
- We now see the tax equity credits as a true sale, rather than debt in our previous assessment, for EDP, likely to improve S&P Global Ratings-adjusted funds from operations (FFO) to debt by more than 150 basis points. We note this is not triggered by any change in EDP's tax equity contracts.
- We are therefore affirming our 'BBB-/A-3' long-term rating on EDP.
- The stable outlook reflects our expectation that, over the next two years, stronger operating performance and deleveraging will uphold EDP's financial risk profile, namely adjusted FFO to debt at about 16% in 2020 and adjusted debt to EBITDA declining to about 4.7x, from 5.0x in 2019.

Rating Action Rationale

We now consider EDP's liabilities related to tax equity investments in the U.S. as true-sales rather than as debt. We base this on:

- In all EDP's contracts there is no minimal repayment every year;
- The contract has a call option on the typical 5% residual;
- There is no mandatory all-in return to be provided since it is linked to the performance of the project; and
- There is no recourse to EDP, unless the company breaches any representation.

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This benefits EDP's credit metrics compared with our previous base-case projections. Not considering tax equity credits in EDP's S&P Global Ratings-adjusted debt boosts the adjusted FFO-to-debt ratio by about 100 basis points (bps) in the historical numbers and of more than 150 bps in the forecasts, with our expectation of EDP accelerating its renewables investments in the U.S. over 2020-2022. Adjusted debt to EBITDA improves by 0.4x since tax equity credits were representing close to 10% of adjusted debt in 2019.

Rating headroom should improve over 2021-2022, underpinned by sound performance this year. For 2020, we expect EDP's reported EBITDA to reach at least €3.6 billion (€3.8 billion considering Viesgo on a pro-forma basis, according to our estimates), with COVID-19-related effects mainly stemming from:

Foreign exchange, notably a devaluation of the Brazilian real, which we expect to have an impact on EBITDA of up to €150 million. Although having a negative profit-and-loss effect, we expect this local currency depreciation to reduce net debt, mitigating the impact on credit metrics.

Lower electricity volumes sold and higher receivables, which would translate into an effect on working capital--expected to be a maximum of €500 million. Thanks to the aforementioned disposals and the resilient performance expected in 2020, adjusted FFO to debt should remain at about 16% on a pro-forma basis.

Over 2021-2022, we expect EDP will continue to focus on its large capex program, notably in renewables, which will lead to negative free cash flow after capex and dividends of about €300 million. EBITDA will increase, more so than adjusted debt, on the back of capacity additions. We forecast adjusted EBITDA (including Viesgo) will increase to about €3.7 billion in 2021 and €3.9 billion in 2022, with adjusted debt remaining at around €16.0 billion, considering from tax equity investments are not anymore a debt adjustment. This would translate into an increase of adjusted FFO to debt to more than 19% in 2022, compared with slightly at about 16% in 2020.

For a more detailed overview of EDP's business risk profile please refer to "EDP - Energias de Portugal S.A.," published Aug. 19, 2020, on RatingsDirect.

Outlook

The stable outlook reflects our expectation that EDP's FFO to debt, as adjusted by S&P Global Ratings, will surpass 16% in 2020, and adjusted debt to EBITDA will strengthen to about 4.7x, from 5.0x in 2019. We believe the company's financial risk profile will improve over the next two years on stronger operating performance and the sale of merchant assets and retail B2C clients in the Iberian Peninsula, announced in the past nine months, for more than €2.7 billion. We estimate that the Viesgo acquisition will not derail credit metric improvement since it is neutral from a cash flow perspective with EDP having completed the €1.02 billion capital increase in August 2020. The acquisition is slightly positive from a business risk perspective.

Downside scenario

We could downgrade EDP if its FFO to debt drops materially below 16% over 2020-2022. We would also downgrade EDP if the company were unable to materially deleverage over 2020-2022, with adjusted debt to EBITDA remaining materially above 4.5x.

One or more of the following scenarios could prompt a negative rating action:

- Continuously challenging conditions in the Iberian power generation market;

- Any deviation from the improvement in the leverage-reduction target presented in the 2019-2022 plan;
- A material heightening of Portuguese and (secondarily) Brazilian country risk (including adverse regulatory or fiscal effects);
- Larger-than-expected foreign exchange effects in 2020; and
- An inability to achieve its asset-rotation target over 2020-2022.

Upside scenario

Ratings upside over the next two years would require EDP to achieve FFO to debt above 20% under its current business risk profile.

Company Description

EDP is a vertically integrated utility company. It is the largest generator, distributor, and supplier of electricity in Portugal, and the third-largest electricity generator on the Iberian Peninsula.

EDP is one of the largest wind power operators worldwide, with wind farms for energy generation in the Iberian Peninsula, the U.S., Canada, Mexico, Brazil, France, Belgium, Italy, Poland, and Romania. It also generates solar photovoltaic energy in Portugal, Romania, and the U.S.

In Brazil, EDP is the fifth-largest private operator in electricity generation, with two electricity distribution concessions (EDP São Paulo Distribuição de Energia and EDP Espírito Santo Distribuição de Energia). It is Brazil's fourth-largest private supplier in the liberalized market, and recently entered into power transmission there.

EDP reports its operations under the following three business segments:

- Renewables (61% of fiscal 2019 EBITDA): This segment includes the EDP's hydro, wind, and solar power assets across all geographies. EDP renewables capacity accounts 73% of total installed capacity, equivalent to 20.6 gigawatts (GW) (including Equity MW).
- Networks (26%): This segment includes EDP's electricity distribution activities in the Iberian Peninsula (17%) and Brazil, electricity transmission activity in Brazil and electricity last resort supply activity in Portugal.
- Client Solutions and Energy Management (13%). This segment includes EDP's supply activities in Iberia and Brazil, thermal generation and energy management businesses.

As of Dec. 31, 2019, EDP had an installed capacity of 26.7 GW and generated 66.7 terawatt hours of electricity in 2019, about 66% of which comes from renewables.

Our Base-Case Scenario

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The current consensus among health experts is that COVID-19 will remain a threat until a vaccine or effective treatment becomes widely available, which could be around mid-2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Please refer to "EDP - Energias de Portugal S.A.," published Aug. 19, 2020, for a detailed 2020-2022 base-case scenario for EDP. Key difference in our base case is the treatment of the tax equity investments.

Key metrics

	2019A	2020E	2021E	2022E
EBITDA (bil. €)	3.4	3.3-3.5	3.7-3.8	3.9-4.0
FFO (bil. €)	2.6	2.4-2.6	2.9-3.0	3.0-3.1
Capex (bil. €)	2.3	2.6-2.8	3.0-3.3	2.8-3.2
Dividends (mil. €)	868	860-900	950-1,000	960-1,000
Debt (bil. €)	17.0	16.0-17.0	16.0-17.0	16.0-17.0
FFO/debt (%)	15.0	16.0-17.0	17.5-18.5	18.0-19.0
Debt/EBITDA (x)	5.0	4.5-5.0	4.0-4.5	4.0-4.5

A--Actual. Capex--Capital expenditure. E--Estimate. FFO--Funds from operations. All data is adjusted by S&P Global Ratings.

Liquidity

The short-term rating on EDP is 'A-3'. We view EDP's liquidity as strong, reflecting the company's proactive financing and healthy cash flow. In particular, projected sources of liquidity (predominantly operating cash flow and available bank lines) exceed projected uses (mainly necessary capex, debt maturities, and dividends) by more than 1.5x for the next 12 months and more than 1.0x in the following 12 months. EDP's strong bank relationships, prudent financial discipline, and proven access to the debt capital markets support our assessment of the company's liquidity position as strong.

We estimate that principal liquidity sources for the 12 months from June 30, 2020, include:

- Unrestricted cash of about €1.5 billion.
- About €6.1 billion in available committed lines maturing beyond 12 months. In particular, EDP has a €3.3 billion revolving credit facility (RCF) maturing in 2024 and a €2.1 billion RCF maturing in 2025.
- Forecast cash FFO of about €3.1 billion.
- Asset disposals of about €3.1 billion expected, including €2.2 billion from the sale of Portuguese hydro assets to the consortium led by ENGIE SA, and €515 million from the sale of gas plants and supply portfolio to Total S.A.
- A €1.02 billion capital increase related to the Viesgo acquisition, completed in August 2020.
- $850 million for 7-year senior unsecured bond issuance in September 2020.

For the same period, we estimate that principal liquidity uses include:

- Short-term debt of about €2.5 billion, including subsidiaries' short-term debt.
- Estimated working capital outflows of €350 million.
- An estimated €3.1 billion of gross capex.

- €2.7 billion enterprise value for the acquisition of Viesgo, including €1.1 billion of reported net debt in 2019.
- Dividends of about €910 million, including dividends to subsidiaries' minority shareholders.

Issue Ratings--Subordination Risk Analysis

Capital structure

EDP's policy is to issue most of its debt at the parent company directly or via its financial subsidiary EDP Finance BV, and lend the proceeds to its operating companies. However, we calculate structural subordination to be 29% because of the amount of debt at the subsidiaries, including Viesgo. We think EDP's size, diversity of cash flow generation, financial ring-fencing of its Brazilian subsidiary and direct ownership of a fair amount of operating assets strongly mitigate structural subordination issues.

Analytical conclusions

The issue rating on EDP's senior unsecured debt is 'BBB-', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure. We rate the hybrid bonds 'BB', two notches below EDP's 'bbb-' stand-alone credit profile.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/A-3

Business risk: Strong

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive (Standard volatility table)

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Positive (+1 notch)

Stand-alone credit profile: bbb-

- Group credit profile: bbb-

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- The Energy Transition And COVID-19: A Pivotal Moment For Climate Policies And Energy Companies, Sept. 24, 2020
- The Energy Transition: The Effect Of COVID-19 Economic Recovery Policies, Sept. 24, 2020
- The Energy Transition: Does COVID-19 Bend The Emissions Curve To 2 Degrees?, Sept. 24, 2020
- The Energy Transition: COVID-19 And Peak Oil Demand, Sept. 24, 2020
- The Energy Transition: COVID-19 Undermines The Role Of Gas As A Bridge Fuel, Sept. 24, 2020
- The Energy Transition: COVID-19 Could Make 2020 Crucial For Renewables, Sept. 24, 2020
- Full Analysis: EDP - Energias de Portugal S.A., Aug. 19, 2020
- Portuguese Integrated Electric Utility EDP 'BBB-' Ratings Affirmed On Announced Acquisition Of Viesgo HoldCo, July 17, 2020
- Viesgo Holdco's Financial Policy Likely To Remain Unchanged After Its Acquisition By EDP, July 17, 2020

- EDP's Strategy And Deleveraging Should Continue Despite CEO's Suspension, July 10, 2020
- EDP's Stronger-Than-Expected 2019 Results Sustain 'BBB-' Rating, Feb. 21, 2020
- EDP Advances Deleveraging Plans With Hydro Disposal But Still Managing Limited Credit Headroom Through 2020, Dec. 20, 2019
- A Trio Of "Special Situations" M&A In European Utilities And Their Rating Implications, April 18, 2019
- Portuguese Power Utility EDP Affirmed At 'BBB-/A-3' With Limited Rating Headroom Through 2020; Outlook Stable, April 15, 2019
- Regulatory Support Is Powering Latin America's Utilities, March 8, 2019

Ratings List

Ratings Affirmed	
EDP - Energias de Portugal S.A.	
EDP Finance B.V.	
Issuer Credit Rating	BBB-/Stable/A-3
EDP - Energias de Portugal S.A.	
Senior Unsecured	BBB-
Junior Subordinated	BB
Commercial Paper	A-3
EDP Finance B.V.	
Senior Unsecured	BBB-
Commercial Paper	A-3

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