FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Comision Federal de Electricidad's Ratings at 'BBB-'; Outlook Stable

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Fitch Ratings - Monterrey - 11 Aug 2020: Fitch Ratings has affirmed Comision Federal de Electricidad's (CFE) ratings as follow:

--Long-Term Foreign Currency (FC) Issuer Default Rating (IDR) at 'BBB-'.

--Long-Term Local Currency (LC) IDR at 'BBB-'.

--LC and FC Senior Notes outstanding at 'BBB-'.

--National Long-Term Rating at 'AAA(mex)'.

--National scale debt issuances at 'AAA(mex)'.

--National Short-Term Rating at 'F1+(mex)'.

--Short-Term Certificados Bursatiles Program at 'F1+(mex)'.

The Rating Outlooks for the FC and LC IDRs and the National Long-Term Rating are Stable.

CFE's ratings are equalized with the Mexican sovereign rating, based on Fitch's Government-Related Entities Ratings Criteria (GRE) due to Fitch's assessment of a very strong linkage between both and a strong to very strong incentive of the government to support CFE. The strength of the linkage is considered very strong due to the status, ownership and control by Mexico. Also, the assessment of financial implications for the government in the event of a default by CFE is considered very strong by Fitch. The socio-political implications of a default are considered strong as well, as are the support track record and expectations going forward, which results in a strong to very strong incentive to support the assessment. CFE's Stand-Alone Credit Profile (SCP) is 'bb'.

The ratings also reflect CFE's position as the largest integrated electric utility in Mexico and Latin America and the sole electricity marketer to unqualified users, coupled with its monopoly on transmission and distribution activities, which make it strategically important for the country. The Mexican power system relies on CFE, as it represents around 72.7% of the installed generation capacity as of December 2019 and 75.5% in net generation of electricity. CFE's ratings also reflect the continuing establishment of subsidies, the entity's improved but still above-average technical and non-technical losses and its exposure to exchange rate volatility and use of heavy fuel oil in electricity generation.

Fitch believes CFE has low exposure to the coronavirus pandemic. Fitch expects a 9.1% decline in Mexico's GDP in 2020, followed by 3.4% growth in 2021. Fitch also expects a reduction in CFE's revenue given the lockdown measures that have reduced electricity demand and the contraction of economic activity in the country. Mexico's electricity demand as of June 2020 fell 4.9% compared with the same period in 2019. Lower fuel prices have also decreased the company's revenue but have improved its margins. Fitch is not expecting any material operational or supply chain issues for CFE.

KEY RATING DRIVERS

Strong Linkage With Government: The ratings reflect the company's ownership by the Mexican government, the sovereign's operational interference and the government's incentive to financially support CFE. The government, through the Comision Reguladora de Energia (CRE), directly sets electricity tariffs and establishes subsidies for specific customers. Tariffs with subsidies, which include agricultural and low consumption residential customers, were partially compensated by government payments in 2017, 2018 and 2019, and this is expected to continue for the next few years. For 2019, total transfers from the government to CFE were roughly MXN75.1 billion, and they are expected to remain around MXN70 billion for 2020.

Pandemic Impact Manageable: Fitch expects a decrease in the company's revenue at YE20 of around 3.6% as a result of the implementation of lockdown measures and the gradual reactivation of the economy. The company will report less revenue from the sale of fuels due to lower volume and lower fuel prices. Regarding energy demands, the major drop comes from the industrial sector, but around 30% of the drop-off has been compensated via an increase in demand from the domestic segment. The easing of lockdowns is starting to cause a rebound in energy demand; nevertheless, Fitch expects a 1.8% reduction in demand for 2H20 compared to 2019. As GDP recovers in the medium term, Fitch expects electricity demand to grow accordingly.

Legal Uncertainty Halts Investments: Changes to sector operating rules have created uncertainty that could damage Mexico's attractiveness for power sector investors. Fitch believes Mexico requires considerable private investment in its electricity sector to accommodate demand growth and prevent financial pressure on CFE. In Fitch's opinion, the government is inclined to preserve CFE's market share, dampening reform efforts toward a more competitive, reliable system. Investments in transmission and distribution capacity are required to avoid curtailments in renewable generation. Additionally, CFE's ability to fund projects required to maintain a balanced system is limited without changing its capital structure. The company has approved the "Fideicomiso Maestro de Inversión" initiative, and CFE is analyzing different financial schemes with private sector participation to complement the resources needed to develop CFE's investment program.

Largest Integrated Electricity Utility: As of December 2019, the company had a total installed capacity of 57,872 MW, which includes 14,991 MW from independent power producers (IPP) that generate electricity to CFE and have a monopoly position in transmission and distribution. The government's agenda includes expanding the country's installed capacity to around 70,313 MW by 2033. Fitch estimates Mexico will require a total investment of around USD35 billion for generation capacity during the next 15 years to address its growth plan. Fitch expects that the bulk of this amount should be funded by CFE, with the rest coming from private investors.

Strategically Important: Fitch believes CFE's scale of operations, position as the sole electricity marketer to unqualified users and monopoly position on transmission and distribution activities make the company strategically important for the country. Energy reform laws enable CFE to apply certain tariffs to private investors (PI) who participate in the wholesale electricity market (WEM) and require usage of CFE's transmission and distribution network. The energy reform also enables the company to enter into agreements with PI to develop and finance the generation, transmission and distribution infrastructure on its behalf.

Lower Fuel Prices Improve Profitability: CFE margins improved to around 33% as of June 2020 from roughly 26% as of December 2019, mainly as a result of lower fuel prices. Electricity prices fell due to the importing of cheap natural gas from the U.S. and the entrance of pipeline capacity. Over the long term, electrical losses have declined to approximately 10.97% as of 2019 from 16.1% in 2010. The company's target is to reduce electricity distribution losses to 6% by 2024; this value is considered a best practice in the industry. Also, CFE seeks to limits its foreign exchange (FX) exposure with exchange rate derivatives. The company's target is to have a maximum FX exposure of 15%.

Manageable Debt Maturity Profile: As June 30, 2020, total debt was MXN533.7 billion (excluding MXN584.9 billion related to recognition of a liability for the right of usage of assets under IFRS16) and comprises MXN240.6 billion of documented debt, MXN166.2 billion of PIDIREGAS and MXN126.8 billion related to capital leases. The leverage level as of June 2020 was 3.1x, compared to 3.4x in 2019 and 5.4x in 2016 (adding back the estimated actuarial cost of labor obligations into EBITDA). CFE's debt maturity profile is manageable, with MXN43.3 billion maturing in the short term, versus MXN139 billion in cash and broad access to bank and stock market debt. Fitch estimates that, over the next three years, CFE's leverage will be around 3.0x as a result of stable debt levels.

Stand-Alone Credit Quality: CFE's stand-alone credit quality is 'bb'. This SCP is supported via the company's stronger capital structure, mostly resulting from continuous cash support from the government to partially compensate subsidies granted to residential and agricultural customers. The stand-alone credit quality is limited by high technical and non-technical losses, exposure to exchange rate volatility, CFE's ongoing use of heavy fuel oil in electricity generation and improvement in unfunded pension liabilities. The ratings incorporate the existing pension plan scheme and its actual unfunded status. Any future changes to the pension plan resulting in an increase to the value of the unfunded pension liability should limit CFE's financial flexibility and credit quality and will pressure the ratings.

Fitch maintained CFE's Environmental, Social and Governance (ESG) relevance score for Financial Transparency of 4; this relates to the quality of financial disclosure and some delays in financial reports in 2019. Fitch also has an ESG Relevance Score of 4 for Governance Structure due to CFE's ownership concentration as a wholly government-owned entity and board independence and effectiveness; this has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

DERIVATION SUMMARY

CFE's 'BBB-' rating mirrors the Mexican sovereign rating given the company's strong linkage with the government and high importance to the country. Compared with other state-owned electric utility companies in Latin America, CFE's IDR is lower than that of the Colombian group Interconexion Electrica S.A. E.S.P (BBB+/Negative).

CFE's ratings are fully supported by the Mexican sovereign rating of 'BBB-'/Stable due to its monopoly position in the country. Interconexion Electrica S.A. E.S.P.'s ratings are higher than the Colombian sovereign rating of 'BBB-'/Negative, reflecting its asset base diversification in terms of segments and geographic operation, resulting in adequate credit metrics.

CFE's IDR is also rated higher than that of the Brazilian company Centrais Eletricas Brasileiras S.A. (Eletrobras; 'BB-'/Negative). Eletrobras' linkage with the government is strong given Brazil's 51% ownership of the company's voting shares and its broad control over Eletrobras' operational, strategic and financing activities. Brazil also guarantees 15% of Eletrobras' consolidated on-balance sheet debt.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

--Revenue declining 3.6% as of YE20 due to lower energy demand and lower fuel prices.

--Higher EBITDA margins improving to around 33% as of YE20 due to cheaper fuel prices (adding the estimated actuarial cost of labor obligations into EBITDA).

--A capex ratio of around 9.5%.

--Expectations of government support of around MXN70 billion in 2020.

--A total debt/EBITDA ratio (Pre-IFRS16) of roughly 3.0x over the next three years.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--An upgrade of the Mexican sovereign rating.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A downgrade of Mexico's sovereign rating.

--The perception of a lower degree of linkage between CFE and the sovereign as a result of a weak operating and financial profile.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity Profile: CFE's liquidity position is adequate as a result of adequate cashflow from operations, a strong cash position, a comfortable amortization profile, sustained funds received from the government and good access to bank and capital markets. As of June 2020, CFE reported total cash on hand of MXN139 billion, compared with short-term debt of MXN43.3 billion. As of the same date, total debt amounted to MXN553.7 billion (excluding recognition of the liability for the right of usage of assets of MXN584.9) and comprised MXN240.6 billion of documented debt, MXN166.2 billion of PIDIREGAS and MXN126.8 billion related to capital leases. The company has undrawn committed credit lines in USD and MXN that support its liquidity position.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

CFE's ratings are linked to Mexico's sovereign rating.

ESG CONSIDERATIONS

Comision Federal de Electricidad (CFE): Governance Structure: 4, Financial Transparency: 4

Except for the matters discussed above, the highest level of ESG credit relevance, if present, 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.

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 12 Nov 2019)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

National Scale Rating Criteria (pub. 08 Jun 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Comision Federal de Electricidad (CFE)	EU Endorsed

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