FitchRatings

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

Fitch Ratings - Monterrey - 18 Jul 2022: Fitch Ratings has affirmed Comision Federal de Electricidad's (CFE) Long-Term Foreign Currency Issuer Default Rating (FC IDR) and Local Currency Issuer Default Rating (LC IDR) at 'BBB-', its National Long-Term Rating at 'AAA(mex)' and its National Short-Term Rating at 'F1+(mex)'. The Rating Outlooks for the FC and LC IDRs and the National Long-Term Rating are Stable.

CFE's ratings remain equalized with Mexico's sovereign rating based upon Fitch's Government-Related Entities Ratings Criteria. Fitch has lowered its assessment of CFE's Standalone Credit Profile (SCP) to 'bb-' from 'bb'.

Key Rating Drivers

Weakening Standalone Credit Profile: The revision of CFE's SCP reflects the entity's weakening cash flow due to insufficient government subsidies, to offset the increased cost of operations and elevated capex, resulting in a deterioration of its liquidity position. Fitch's rating case assumes that negative FCF will be financed with incremental debt. Fitch expects CFE to have a high gross leverage profile, defined as total debt to EBITDA, at 5.0x and a weaker FFO to interest coverage at 2.0x or less over the rating horizon. Both metrics are more consistent with the 'B' rating category.

Government Linkage: Fitch has reassessed CFE's relationship with the Mexican government under our GRE Criteria following the deterioration in the company's SCP. CFE generated negative FCF of MXN52 billion during 2021 due to elevated fuel prices and insufficient government transfers. As a result, Fitch has amended its assessments of CFE's Support Track Record and Expectations and its Financial Implications of Default factors to "Strong" from "Very Strong". The GRE factors Status, Ownership and Control, and Socio-Political Implications of Default, remain "Very Strong" and "Strong", respectively.

Fitch has lowered CFE's overall GRE support score to 35 from 50 due to the GRE factor revisions, but the SCP continues to justify equalization of the ratings. CFE is highly important to Mexico as its largest integrated electric utility, and it is the only domestic entity allowed to both transmit and distribute electricity. If Fitch were to lower the SCP to 'b+', a support score of 35 would result in a top down minus one rating approach and CFE would be downgraded to 'BB+'.

Insufficient Government Transfers: Government transfers totaled MXN70.3 billion in 2021, and Fitch projects they will increase to around MXN118 billion in 2022, a level insufficient to eliminate the company's negative FCF. The Mexican government directly sets electricity tariffs to high consumption industrial, commercial services and domestic users through the Energy Regulatory Commission (CRE), while the Ministry of Finance and Public Credit (SHCP) establishes transfers to offset subsidized prices for the agricultural sector and low-consumption domestic users.

Legal Uncertainty Halts Investments: The government's proposed changes to the electricity sector have created uncertainty for private investors. This will diminish their investments in the sector and could lead to a material increase in CFE's capex burden in the near future. The Programa de Desarrollo del Sistema Electrico Nacional 2022-2036 (PRODESEN) projects a need for a growth in energy production to 110 GW from 86 GW by 2026. Fitch estimates that investment in generation to achieve this goal would total between USD26 billion and USD32 billion. To complement the generation capacity growth, Fitch projects the country will also need investments of approximately USD20 billion in transmission and distribution.

Negative FCF: CFE's current capital investment plan calls for MXN516 billion (USD25 billion) of investments between 2022 and 2028. Around 71% of CFE's planned capex will be invested during 2022-2024, which will result in negative FCF generation unless the government contributes equity or increases transfers substantially beyond Fitch's projected subsidy level of MXN118 billion for 2022. These investments levels fall far short of what Fitch believes is required to avoid a shortfall in electricity supply, which would be around USD10 billion per year for the next 15 years.

Natural Gas Price Exposure: Mexico's domestic natural gas production is not high enough to satisfy internal demand, and storage facilities are limited. This exposes CFE to shortages and fluctuations in natural gas prices and FX rates as more than 60% of CFE's installed capacity requires natural gas for electricity generation. The unusual winter storm in Texas during February 2021 led to elevated prices as has the Russia-Ukraine conflict. Natural gas represented around 80% of CFE's energy generation costs in 2021. CFE initiated a Commodities Hedging Program to reduce this exposure, but as of March 2022 only 21% of its fuel requirements were hedged, though the company plans to increase that coverage substantially by 2022-2023.

Increased Leverage: CFE's leverage level during the LTM ended March 31, 2022 was 11.3x, a sharp increase from 3.2x in 2020. Fitch's calculations add back the estimated actuarial cost of labor obligations into EBITDA. CFE was not able to transfer the natural gas price increase to its final customers during 2021, which pressured the company's operating margins increasing its leverage ratios. Fitch expects that the stabilization of fuel prices in conjunction with the company's strategy to hedge its exposure, tariffs increases and additional subsidies could strengthen its EBITDA generation and decrease its leverage ratio. Fitch's projected ND/EBITDA ratio remains elevated at 4.5x in 2022.

Derivation Summary

CFE's 'BBB-' rating mirrors those of the Mexican sovereign, 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 the Colombian group Interconexion Electrica S.A. E.S.P (BBB/Stable). CFE's ratings are fully supported by the Mexican sovereign rating of 'BBB-'/Outlook Stable due to its exclusively reserved transmission and distribution activities in the country.

Interconexion Electrica S.A. E.S.P.'s (ISA) ratings are two notches above the Colombian sovereign rating of 'BB+'/Outlook Stable due to moderate linkage with the Colombian government, a low business risk profile, asset base diversification across six countries in Latin America and an adequate liquidity position. A negative rating action on the Colombia sovereign rating would impact ISA's rating to preserve the two-notch differential with its parent.

CFE's IDR is also rated higher than Brazilian company Centrais Eletricas Brasileiras S.A. (Eletrobras; BB-/Stable). Eletrobras' linkage with the Brazilian sovereign rating (BB-/Negative) has weakened following the privatization of the company's shares. Fitch rates Electrobras on a standalone basis since the government now owns less than 50% of the shares and will likely only control one or two of the 11 board seats after the board election.

Key Assumptions

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

- Revenues to increase around 8.7% driven by higher government support and higher fuel prices;

- EBITDA margins improving to around 19.5% (adding the estimated actuarial cost of labor obligations into EBITDA);

- Capex of around MXN125 billion during the next three years;

- Total government support of around MXN118 billion in 2022;

- Total debt/EBITDA ratio (Pre-IFRS16) near 5.0x at YE2022.

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; Fitch outlined the following negative rating sensitivities in its press release on the sovereign on May 17, 2022:

--Macro: A weakening in the consistency and credibility of the macroeconomic policy framework (e.g., if unorthodox policy interventions become more widespread, negatively affecting growth prospects and/or leading to a reassessment of the upward notching in our rating adjustment for tis factor);

--Public Finances: A marked upward trajectory in the gross general government debt/GDP ratio (e.g., due to fiscal deterioration or weaker economic growth;

--Structural: deterioration in governance indicators that widens the gap further to the scores of 'BBB ' category peers and further undermines the business climate.

--A deterioration of the SCP to a 'b+' level due to total debt to EBITDA of 5.0x or higher, FFO to interest coverage of 3.0x or below, and/or weakened of liquidity.

--Government support at a level that does not allow CFE to be FCF neutral.

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 debt totaled MXN549 billion as of March 2022 (excluding MXN540.3 billion related to the recognition of the liability for the right of usage of assets under IFRS16). The debit is composed of MXN325 billion of financial debt, MXN120 billion of PIDIREGAS investment programs, and MXN95 billion related to capital leases.

CFE's liquidity position is adequate as a result of the company's recent liability management, government subsidies, low debt amortization, available undrawn committed credit lines in USD and MXN, and access to bank and capital markets. The company's SCP deterioration limits its flexibility. As of March 2022, CFE reported total cash on hand of MXN127.8 billion compared with short-term debt of MXN41.1 billion.

Issuer Profile

CFE is the largest electricity generator in Mexico with a total installed capacity of 59,561 MW, including 16,081MW from independent power producers. The company has exclusively reserved the transmission and distribution activities in the country.

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

CFE has an ESG Relevance Score of '4' for Governance Structure due to ownership concentration as a wholly government-owned entity and due to board independence and effectiveness, which have a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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 Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Applicable Criteria

Corporate Rating Criteria (pub.15 Oct 2021) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub.30 Sep 2020)

National Scale Rating Criteria (pub.22 Dec 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), v8.0.3 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Comision Federal de Electricidad (CFE)	EU Endorsed, UK Endorsed

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