FitchRatings

RATING ACTION COMMENTARY

Fitch Rates CFE´s Issuance at 'BBB-'; Affirms Ratings

Wed 21 Jul, 2021 - 14:35 ET

Fitch Ratings - Monterrey - 21 Jul 2021: Fitch Ratings has affirmed Comision Federal de Electricidad's (CFE) ratings including its Long-Term Foreign Currency (FC) and Local Currency Issuer Default Ratings (IDRs) at 'BBB-'; the National Long-Term Rating at 'AAA(mex)' and National Short-Term Rating at 'F1+(mex)'. Fitch also has affirmed the LC and FC senior notes at 'BBB-' and the national scale debt issuances at 'AAA(mex)'. The Rating Outlooks for the FC and LC IDRs and the National Long-Term Rating are Stable.

Fitch has assigned a 'BBB-' rating to CFE's USD850 million notes due in 2033. The notes will pay semi-annual interest, and proceeds will be used to refinance existing indebtedness and for general purposes. The notes will be guaranteed by CFE Distribucion, CFE Suministrador de Servicios Basicos, CFE Transmision, CFE Generacion I, CFE Generacion II, CFE Generacion III, CFE Generacion IV, CFE Generacion V and CFE Generacion VI.

CFE's ratings are equalized with the Mexican sovereign ratings based on Fitch's Government-Related Entities Ratings Criteria. Fitch assesses the linkage between the two entities as very strong and believes the government has a strong to very strong incentive to support CFE. The ratings also reflect CFE's position as the largest integrated electric utility in Mexico and the sole electricity marketer to unqualified users. Its transmission and distribution activities are exclusively reserved by the Mexican state, which makes it strategically important for the country.

The CFE 23-1 CB Issuance has been withdrawn as the issuance was not issued in the market.

KEY RATING DRIVERS

Strong Government Linkage: The ratings reflect CFE's ownership by the Mexican government, the sovereign's operational interference, and its social and financial incentives to support the company. Through the Energy Regulatory Commission (CRE) the government directly sets electricity tariffs while the Ministry of Finance and Public Credit (SHCP) establishes user subsidies. Tariffs on subsidized agricultural and low consumption residential users were partially offset with government contributions in 2017-2020, and it is expected to continue for several years. Total government transfers to CFE in 2020 were MXN70 billion, and a similar amount is expected for 2021.

Temporarily Weakened Credit Metrics: In early February 2021, the unusual winter storm in Texas materially increased the demand of natural gas, affecting the commodity prices and temporarily weakening CFE's credit metrics. More than 60% of CFE's installed capacity requires natural gas for electricity generation, and Texas represents around 86% of total natural gas imports by pipeline from the U.S. to Mexico. Fitch expects that CRE will increase commercial, industrial and high consumption domestic tariffs to compensate for the higher fuel costs throughout the next few months. The Ministry of Finance and Public Credit also transferred in advance MXN21.0 billion to CFE to support liquidity due to the increase in gas prices.

Higher Fuel Prices Decrease Profits: CFE's revenue should increase driven by higher energy demand due to a gradual reactivation of the economy and 5.3% growth of Mexico's GDP. However, CFE's operating margins should decrease in 2021 to around 20.2% vs. 31.5% in 2020 mainly due to higher fuel prices. For 2021 Fitch has increased its price deck projections for natural gas and fuel oil.

Mexico's electricity demand fell 2.2% in 2020 vs. 2019 due to pandemic lockdown measures, and the National Institute of Statistics and Geography (INEGI) reported Mexico's GDP declined 8.5% for 2020. Electrical losses have declined to approximately 11.7% in 2020 from 16.1% in 2010. The company has targeted reduction of electricity distribution losses to 6% by 2024, a level considered best practice in the industry.

Largest Integrated Electricity Utility: As of March 2021, the company had a total installed capacity of 58,655 MW, including 15,837 MW from independent power producers (IPP) that generate electricity to CFE and have a monopoly on transmission and distribution. The Programa de Desarrollo del Sistema Electrico Nacional 2020-2034 (PRODESEN) establishes the generation matrix to grow to 110 GW from 86 GW by 2026. Fitch estimates that the investment could total USD26 billion-USD32 billion as some inefficient capacity retires. To complement the generation capacity growth, the country needs an additional USD20 billion of investment to the transmission and distribution lines to interconnect the systems.

Fitch expects CFE to fund the main amount and the rest to come from private investors (PI). Most of the investments should be funded by CFE's own resources, through the Master Investment Trust, Productive Infrastructure Investment Projects with Deferred Registration in Public Expenditure (Pidiregas) and joint investment. CFE's would need to change its capital structure to fund the projects required to maintain a balanced system.

Strategically Important: CFE's scale of operations, position as 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 the CRE to regulate rates for private generators in the wholesale electricity market (WEM) and use CFE's transmission and distribution network among others. The energy reform also enables the company to enter into agreements with PI to develop and finance the transmission and distribution infrastructures on its behalf.

Legal Uncertainty Halts Investments: Changes to the sector operating rules create uncertainty that could damage Mexico´s attractiveness for power sector investors. Mexico requires considerable private investment in its electricity sector to accommodate demand growth and prevent financial pressure on CFE. 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 of the renewable generation.

The company has approved a Master Investment Trust initiative, and CFE is analyzing financial schemes with private sector participation to complement the resources needed to develop its investment program. The result of the midterm elections to Congress, led to a reduced majority for the president´s party making more difficult for the administration to enact some controversial reforms.

Negative FCF: CFE´s capital investment plan for the next five years amounts around MXN281 billion. Around 80% of the total amount will be invested during 2021-2023, which should pressure the company's FCF generation. Going forward a strong cash flow from operations and lower capex levels should move the FCF to positive.

Manageable Debt Maturity Profile: As of March 31, 2021, total debt was MXN544.6 billion (not including MXN516.2 billion related to the recognition of the liability for the right of usage of assets under IFRS16), and is composed of MXN304.6 billion of documented debt, MXN131.7 billion of PIDIREGAS, and MXN108.3 billion related to capital leases. The leverage level LTM as of March was 5.1x compared with 3.4x in 2019 (adding back the estimated actuarial cost of labor obligations into EBITDA).

CFE's debt maturity profile is manageable, with MXN74.6 billion maturing in the short term, compared with MXN134.8 billion in cash and broad access to bank and stock market debt. For YE2021, CFE leverage will increase to around 4.2x and start decreasing in 2022 to 3.5x as a result of higher capex levels and the stabilization of fuel prices. CFE also seeks to limits its FX exposure with exchange rate derivatives. The company´s target is to have a maximum Fx exposure of 15%.

Standalone Credit Profile: CFE's standalone credit quality is 'bb'. This SCP is supported on the stronger capital structure of the company mostly resulting on the continuous cash support from the government to partially compensate the subsidies granted to the residential and agricultural customers. The standalone credit quality is limited by high technical and non-technical losses, exposure to exchange rate volatility and unfunded pension liabilities.

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 Issuer Default Rating (IDR) is lower than 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-'/Outlook Stable due to its monopoly position in the country.

Interconexion Electrica S.A. E.S.P.'s ratings are two notches above the Colombian sovereign rating of 'BBB-'/Outlook Negative, as the linkage with the Colombian government is considered moderated, also reflecting its low business risk profile, asset base diversification across six countries in Latin America and 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-/Negative). Eletrobras' linkage with the government is strong given Brazil's 52% ownership of the company's voting shares and its broad control over Eletrobras' operational, strategic and financing activities. Brazil also guarantees 13% of Eletrobras' consolidated on-balance sheet debt.

KEY ASSUMPTIONS

- Revenue increasing 20.4% at YE2021 due to higher energy demand and higher fuel prices.

- Lower EBITDA margins of around 20.2% YE2021 due to higher fuel prices (adding the estimated actuarial cost of labor obligations into EBITDA).

- Capex ratio or around 11% in 2021 and 16% in 2022.

- Total government support of around MXN70 billion in 2021 and MXN80 billion in 2022.

- Total Debt/EBITDA ratio (Pre-IFRS16) near 4.2x as of YE2021.

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 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 cash flow from operations, strong cash position, comfortable amortization profile, sustained funds received from the government and good access to bank and capital markets. As of March 2021, CFE reported total cash on hand of MXN134.8 billion compared with short-term debt of MXN74.6 billion. On the same date, total debt amounted to MXN544.6 billion (excluding the recognition of the liability for the right of usage of assets of MXN516.2) and is composed of MXN304.6 billion of documented debt, MXN131.7 billion of PIDIREGAS, and MXN108.3 billion related to capital leases. The company has undrawn committed credit lines in USD and MXN that supports its liquidity position.

ISSUER PROFILE

CFE is the largest electricity generator in Mexico. At the end of December 2020, with a total installed capacity of 59,004 MW, which includes 15,989MW from independent power producers that generate electricity for CFE. The company's position as sole electricity marketer to unqualified users (all users which consume less than 1 MW) and its monopoly on transmission and distribution activities make the company strategically important for the country. Additionally, to the sale of electricity, the energy reform allows CFE to sell natural gas to third parties and to generate income through the rent of its transmission and distribution network.

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 board independence and effectiveness, which has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

Fitch has changed CFE's Social and Governance (ESG) relevance score for Financial Transparency to '3' from '4' related to the improvements of the company in quality, disclosure and timely of the financial statements.

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

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Velia Patricia Valdes Venegas
Associate Director
Primary Rating Analyst
+52 81 4161 7049
velia.valdes@fitchratings.com
Fitch Mexico S.A. de C.V.

Prol. Alfonso Reyes No. 2612, Edificio Connexity, Piso 8, Col. Del Paseo Residencial, Monterrey 64920

Paula Bunn
Associate Director
Secondary Rating Analyst
+1 312 368 3218
paula.bunn@fitchratings.com

Sergio Rodriguez Garza, CFA
Senior Director
Committee Chairperson
+52 81 4161 7035
sergio.rodriguez@fitchratings.com

MEDIA CONTACTS

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

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

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

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), 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, UK Endorsed

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