FitchRatings

RATING ACTION COMMENTARY

Fitch Maintains Rating Watch Negative on EPM's 'BB+' Long-Term IDRs

Tue 05 Apr, 2022 - 14:41 ET

Fitch Ratings - New York - 05 Apr 2022: Fitch Ratings has maintained the Rating Watch Negative (RWN) on Empresas Publicas de Medellin E.S.P.'s (EPM) 'BB+' Foreign and Local Currency Issuer Default Ratings (IDRs) and on its 'AAA(col)' national scale Long-Term rating. Additionally, the RWN on the company's senior unsecured debt ratings of 'BB+' and on the standalone credit profile (SCP) of 'bbb-' has been maintained. The SCP assumes the company is not owned by the Municipality of Medellin and will not receive state support should the need arise. Fitch has also withdrawn the national Long-Term rating of the international Global COP 2021 issuance, which was repaid in full.

EPM's ratings reflect strong ownership and control by its owner, the city of Medellin (BB+/Stable). The company's business risk is low resulting from its diversification and characteristics as a utility service provider. The company's ratings also reflect its somewhat aggressive growth strategy and solid credit protection measures supported by moderate projected leverage, healthy interest coverage and an adequate liquidity position.

EPM's RWN reflects continued uncertainty regarding the closure of Ituango's blocked Auxiliary Diversion System since April 28, 2018, and final cost over-runs of its Ituango project. The possibility of major flooding downstream from the project exists until the diversion tunnel is closed. While the likelihood of this is remote, the environmental, financial and reputational damage to the company could be significant. Fitch's expectation

is that 300MW of the project will be online by mid-2022. The company has a commitment with the regulator to bring the first two 300MW units online by Nov. 30, 2022. The resolution of the Rating Watch may extend longer than six months given these uncertainties.

KEY RATING DRIVERS

Strong Linkage with Parent: EPM consistently contributes significant cash flows in the form of dividends to its parent, the city of Medellin (BB+/Stable). These distributions comprised 20% of the city's total revenues in 2021, and have exceeded government revenues by 20% four out of the last five years. Under Fitch's criteria, a government-related entity that sustainably generates more than 10% of the government's revenues is considered a strong linkage factor that would lead to an equalization of the ratings.

2022 Ituango Entry Expected: Fitch continues to maintain the RWN until further confirmation that the diversion and auxiliary tunnels are appropriately plugged. The tunnels are expected to be secured by the end of 2022 as the company prioritizes the completion of its first two units to meet its firm energy commitment to the system and the tunnels are not part of the critical route to produce electricity. As of September 2021, the company reported 93.4% progress on pre-plug 2 of the right deviation tunnel. Fitch expects two 300MW units will come online per year between 2022-2025, and that once complete, Ituango will add over USD800 million to the company's generation revenue.

Insurance Payment Improves Liquidity: The USD633 million final lump sum insurance payment received from Mapfre Seguros Generales de Colombia S.A. in January 2022 for the Ituango claim bolsters EPM's liquidity and is credit positive. This is in addition to the USD150 million received in 2019 and USD200 million received from Mapfre in 2020 for a total of USD983 million. While the funds are segregated and earmarked for the Ituango project, they do relieve pressure on EPM from selling assets to fund capex. Fitch expects that with the final payment, the company will have the funds necessary to complete the project, which is ~COP3 trillion, or USD769 million, as of the beginning of 2022.

Deleveraging Expected: EPM's consolidated gross leverage, defined as total debt to EBITDA, will average 3.2x between 2022-2025. Leveraged peaked at 4.7x in 2020 as poor demand affected the company's distribution businesses, low hydrology impacted generation and Ituango incurred additional cost overruns and recovered to 3.7x in 2021. Gross leverage is expected to be 3.0x in 2025 and net leverage 2.7x. The deleveraging trend can be attributed to tariff increases at the company's distribution businesses, the

normalization of operations at newly acquired Afinia and Ituango's generation units coming online, the first of which is expected in July 2022 and the second in October 2022.

Moderate Regulatory Risk Exposure: EPM's exposure to regulatory risk is low. The bulk of EPM's consolidated revenues is generated by regulated tariffs or medium-term contracts. The latter exposes the company to potentially sustained low electricity prices. Historically, Colombian regulatory entities have ruled independently from the central government and have provided a fair and balanced framework for both companies and consumers. EPM's diversified business profile further mitigates the company's regulatory risk, as a simultaneous tariff decrease across all businesses is unlikely.

Afinia Grows Distribution Business: Fitch views EPM's assumption in September 2020 of CaribeMar, a coastal electricity distribution company renamed Afinia, as positive for the business and credit neutral. Fitch estimates that once the Afinia business is stabilized in 2023, it will add ~USD1.2 billion in revenue and USD150 million in EBITDA. Fitch estimates capital expenditures of COP3.6 trillion, or USD935 million between 2022-2025. This investment will be necessary to lower high energy losses, which stood at roughly 28% in 2021 with the goal to lower this amount to below 22% by 2024.

Stable Cash Flow Profile: EPM has a stable and predictable cash flow profile supported by regulated businesses in investment-grade markets. Fitch estimates 83% of EPM's 2021 EBITDA was derived from its energy business, where its generation segment comprised 33%; 43% was distribution; and the gas and transmission segments combined for 7%.

EPM's distribution business operates in highly regulated markets, mostly concentrated in Colombia, where it is the largest distributor in the country, with a market share of 38.5%, which includes newly added Afinia's 13.7% market share. Fitch estimates that 17% of the company's EBITDA comes from its water and waste management services.

Interference Weakens Corporate Governance: Fitch views EPM's corporate governance as weak due to the strong influence exerted by the company's owner, the city of Medellin. This follows a lawsuit against the Ituango project insurers and contractors and the contemplated change of the company's social objective in 2020, which prompted the resignation of all eight independent board members.

EPM has an ESG Relevance Score of '4' for Governance Structure due to its nature as a majority government-owned entity and the inherent governance risk that arises with a dominant state shareholder. This has 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.

DERIVATION SUMMARY

EPM's ratings are linked to those of its owner, the Municipality of Medellin (BB+/Stable), due to the latter's strong ownership and control over the company. The company's low business-risk profile is commensurate with that of Grupo Energia Bogota S.A. E.S.P.'s (BBB/Stable), Enel Americas S.A. (A-/Stable), AES Andes (BBB-/Stable), Enel Colombia S.A. E.S.P. (BBB/Stable) and Promigas (BBB-/Stable).

Fitch projects EPM's total leverage to average 3.2x over the rating horizon and 2.8x on a net basis. This is above AES Andes' expected average gross and net leverage of 2.6x and 1.9x and Enel Colombia's at 1.7x and 1.6x and below Promigas', which is expected to be 3.5x and 3.3x. In 2025, Fitch expects gross and net leverage to be 3.0x and 2.7x, respectively, reflecting advances in the Ituango project, an increase in rates at EPM's electricity distribution businesses and the normalization of operations at newly-acquired Afinia.

EPM also compares well with electricity generation peers that have national ratings, namely Enel Colombia S.A. E.S.P., Isagen S.A. E.S.P. and Celsia Colombia S.A. E.S.P., all rated 'AAA(col)'. Similar to peers, EPM has an efficient portfolio of low-cost hydro assets. In 2021, EPM ranked second in installed capacity behind Enel Colombia and first in generation, ahead of Isagen and Enel Colombia, which were second and third, respectively.

KEY ASSUMPTIONS

--Ituango units come online at a rate of two per year from 2022-2025 with no penalties or significant further delays;

--Generation load factor of approximately 50% over the rated horizon;

--No dividends from UNE expected over the rated horizon;

--Dividend payout of 55% of previous year's net income;

--No divestments in 2022 or the rating horizon;

--No additional payments for the Ituango claim from insurance companies or other parties following the USD633 million payment in January 2022;

--Capex of COP7.3 trillion in 2022, COP5.9 trillion in 2023, COP5.4 trillion in 2024 and COP4.8 trillion in 2025;

--Electricity spot prices of COP250/KWh in 2022, COP230/KWh in 2023, COP200/KWh in 2024 and COP180/KWh in 2025.

RATING SENSITIVITIES

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

--Although unlikely in the near term, Fitch may consider a positive rating action if there is a positive rating action on the company's owner, the city of Medellin;

--Fitch may consider a resolution of the RWN once the company has secured the second deviation tunnel at its Ituango project, which Fitch expects by late 2022. In such a case, the Rating Outlook for the city of Medellin would likely apply.

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

--A negative rating action on the city of Medellin's ratings;

--Failure to bring the first 300MW two units of Ituango online by the November 2022 deadline, an incurrence of penalties or loss of guarantees related to delays or the materialization of significant cost overruns and contingencies at the project that weaken the company's liquidity

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

Strong Liquidity: EPM is expected to have strong liquidity during 2022 after ending 2021 with a consolidated cash equivalents balance of COP4.9 trillion, or USD1.25 billion. This total includes COP1.8 trillion, or USD455 million, held directly at the parent company. In January 2022, the company received USD633 million from Mapfre as a final payment for the Ituango insurance claim. While the proceeds will be earmarked for the Ituango project, they will provide the company with the necessary funds to complete project. As of Dec. 31, 2021, the company had COP3.6 trillion, or USD935 million, in available credit lines, USD40 million of which were committed credit lines. All credit lines are in USD.

Currently, the company's dividend policy is expected to remain in place despite the cash flow impact derived from Ituango's delay. Historically, EPM has transferred on average between 45% and 55% of its net income to the city of Medellin in the form of dividends. EPM's transfers to Medellin have historically represented approximately 20% to 30% of the city's investment budget. Although not likely in the near term, an increase in the company's dividend distribution policy could pressure its FCF generation, which is already expected to continue to be negative in the near term as the company continues to execute its investment plan.

ISSUER PROFILE

Founded in Medellin Colombia in 1955, EPM participates in the generation, transmission, distribution and commercialization of electricity, the distribution and commercialization of natural gas and the provision of water, sewage and waste management services.

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

EPM's ratings are capped by that of its owner, the city of Medellin ('BB+'/Stable).

ESG CONSIDERATIONS

Empresas Publicas de Medellin E.S.P. (EPM) has an ESG Relevance Score of '4' for Governance Structure due to its nature as a majority government-owned entity and the inherent governance risk that arises with a dominant state shareholder. This has 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.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Empresas Publicas de Medellin E.S.P. (EPM)	LT IDR BB+ Rating Watch Negative Rating Watch Maintained	BB+ Rating Watch Negative
	LC LT IDR BB+ Rating Watch Negative Rating Watch Maintained	BB+ Rating Watch Negative
	Natl LT AAA(col) Rating Watch Negative Rating Watch Maintained	AAA(col) Rating Watch Negative
senior unsecured	LT BB+ Rating Watch Negative Rating Watch Maintained	BB+ Rating Watch Negative
senior unsecured	Natl LT AAA(col) Rating Watch Negative Rating Watch Maintained	AAA(col) Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Lincoln Webber, CFA, CAIA
Director
Primary Rating Analyst
+1 646 582 3523
lincoln.webber@fitchratings.com
Fitch Ratings, Inc.
Hearst Tower 300 W. 57th Street New York, NY 10019

Jose Luis Rivas
Director
Secondary Rating Analyst
+57 601 443 3701
joseluis.rivas@fitchratings.com

Saverio Minervini
Senior Director
Committee Chairperson
+1 212 908 0364
saverio.minervini@fitchratings.com

MEDIA CONTACTS

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

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

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

Metodología de Calificación de Entidades Relacionadas con el Gobierno (pub. 12 Nov 2020)

National Scale Rating Criteria (pub. 22 Dec 2020)

Metodología de Calificaciones en Escala Nacional (pub. 22 Dec 2020)

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

Metodología de Calificación de Finanzas Corporativas (pub. 02 Dec 2021)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.2 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Empresas Publicas de Medellin E.S.P. (EPM)	EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders'™ relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be acc+u+rate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not

solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.
Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the “NRSRO”). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Corporate Finance Utilities and Power Latin America Colombia