FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - New York/Bogota - 03 Apr 2023: 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 its 'AAA(col)' National Scale Long-Term rating. Additionally, the RWN on EPM's 'BB+' senior unsecured debt ratings and on the 'bbb-' standalone credit profile (SCP) has been maintained. Finally, Fitch maintained EPM Inversiones S.A.'s 'AAA(col)' National Scale Long-Term rating on RWN and affirmed the National Short-Term rating at 'F1+(col)'.

EPM's ratings reflect strong ownership and control by its owner, the city of Medellin (BB+/Stable). EPM Inversiones' rating is equalized with that of EPM's given the existence of legal, operational and strategic incentives for EPM to support it.

EPM's RWN reflects continued uncertainty regarding the closure of Ituango's blocked Auxiliary Diversion System since April 28, 2018. The possibility of major flooding downstream from the project exists until the deviation tunnel is closed. 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 24% of the city's total revenues in 2022 and have made up an average of 21.5% of government revenues over 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.

Ituango Enters Production: The first two units of 300MW each came online in November 2022 meeting the established regulatory deadline. In January and February 2023, Ituango produced 252GWh and 284GWh for a market share of 3.76% and 4.58%, respectively. When complete, the project will consist of eight 300MW units for a total of 2.4GW, or roughly 13% of the country's current installed capacity. Unit 3 is expected to come online in the middle of October 2023, unit 4 at the end of October 2023 and stage 2, consisting of units 5 through 8, in 2026 and 2027. The total project cost is estimated to be COP19.4 trillion (~USD4.0 billion) with an annual EBITDA of roughly COP1.2 trillion (~USD250 million). The company is in the process of receiving construction bids for stage 2. Overall, the project is 90.5% complete.

Fitch continues to maintain the RWN until further confirmation that the right deviation tunnel is appropriately plugged with a 22-meter long concrete wall inside the tunnel to stop any flow of water. The tunnel is expected to be secured by the end of 2023 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 March 2023, the company reported 85.7% progress on pre-plug 2 of the right deviation tunnel, 96.83% on pre-plug 1 and 73.47% in overall progress to secure the tunnel.

Moderate Leverage Expected: EPM's consolidated gross leverage, defined as total debt to EBITDA, will average 3.1x between 2023-2026. Gross leverage is expected to be 3.2x in 2026 and net leverage 2.9x. The deleveraging trend can be attributed to tariff inflation adjustments at the company's distribution businesses, the normalization of operations at Afinia and Ituango's generation units coming online, the first two of which entered production in November 2022. Demanding capex programs at Afinia and Ituango, consistent dividend payments of 55% of net income to the city of Medellin, elevated interest costs on debt and FX adjustments of dollar-denominated debt due to Colombian peso devaluation prevent steeper deleveraging over the rated horizon.

Afinia Grows Distribution Business: Fitch views EPM's assumption of CaribeMar, a coastal electricity distribution company renamed Afinia, as positive for the business and credit neutral. Afinia's service area includes 6.7 million customers in 134 municipalities. Fitch expects Afinia's revenue and EBITDA to be COP5.7 trillion (~USD1.2 billion) and COP800 billion (~USD169 million) in 2023 and to grow to COP6.7 trillion (~USD1.4 billion) and COP1.2 trillion (~USD250 million) by 2026. Fitch estimates capex of COP5.2 trillion, or USD1.1 billion between 2023-2026. This investment will be necessary to lower high energy losses, which stood at roughly 27% in September 2022 with the goal to lower this amount to below 20% by 2025.

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 2022 EBITDA was derived from its energy business, where its generation segment comprised 28%; 55% was distribution and transmission, water and waste management was 15% and gas 2%. 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 38.6%, which includes newly added Afinia's 13.5% market share. EPM's market share in transmission is smaller at 8.17%.

Regulatory Risk: Fitch considers EPM's exposure to regulatory risk to be moderate following president Petro's attempt to control regulations of public services in the country and potential board member turnover at the Electricity and Gas Regulatory Commission (CREG) in 2023 to be increasingly in the president's favor. The administration's stated goal is to lower electricity prices for end users following run-ups in inflation indexes used to adjust tariffs in 2022. Given EPM's concentration in regulated businesses within Colombia, Fitch considers the company's risk exposure to be moderate. Moves by the administration must provide all market players with financial sufficiency and not cause them hardship. Nearly 30% of the group's revenue and 20% of its EBITDA are from outside Colombia.

DERIVATION SUMMARY

EPM's ratings are linked to those of its owner, the city 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. (BBB+/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 3.1x over the rating horizon and 2.8x on a net basis. This is in line with AES Andes' expected average gross and net leverage of 3.1x and 2.9x and Promigas', which is expected to be 3.1x and 2.9x. It is higher than Enel Colombia's at 1.4x and 1.2x. In 2026, Fitch expects gross and net leverage to be 3.2x and

2.9x, 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 2022, 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 3 and 4 come online in late 2023 and units 5 through 8 in 2026 and 2027 with no penalties or significant further delays;

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

--Distribution tariffs increase at half the expected rate of inflation from 2023-2026;

--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;

--Average effective interest rates on financial debt of 14% in 2023, 11.5% in 2024, 8.4% in 2025 and 8.3% in 2026;

--Capex of COP5.7 trillion in 2022, COP7.0 trillion in 2023, COP6.7 trillion in 2024 and COP6.1 trillion in 2025;

--Electricity spot prices of COP250/KWh in 2023, COP220/KWh in 2024, and COP200/KWh in 2025 and 2026.

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 YE 2023. 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;

--An incurrence of penalties or loss of guarantees related to delays or the materialization of significant cost overruns and contingencies at the Ituango 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

Adequate Liquidity: As of 3Q22, EPM had a cash and equivalents of COP3.4 trillion (~USD716 million) at the group level, COP1.2 trillion (~USD252 million) of which was at the parent company. As of 3Q22, the company had consolidated debt of COP28.1 trillion (~USD5.9 billion), the majority of which was due in 2027 and after. The company faces scheduled maturities of COP2.8 trillion and COP2.3 trillion in 2023 and 2024, respectively, which are manageable. In 2022, the company secured a Club Deal committed credit line for USD700 million for a period of five years. The credit line carries an interest rate of the secured overnight financing rate (SOFR) plus 2.2%, or roughly 6.75%. In January 2022, the company received USD633 million from Mapfre as a final payment for the Ituango insurance claim, which financed the project's capex for 2022 and the beginning of 2023.

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

EPM was founded in Medellín, Colombia, in 1955 to provide public utility services. Through its two main business units, the energy business and the water business, EPM currently 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 the ratings of its owner, the city of Medellin.

ESG CONSIDERATIONS

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
EPM Inversiones S.A.	Natl LT	AAA(col) Rating Watch Negative	Rating Watch Maintained	AAA(col) Rating Watch Negative
	Natl ST	F1+(col)	Affirmed	F1+(col)

VIEW ADDITIONAL RATING DETAILS

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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. 28 Oct 2022) (including rating assumption sensitivity)

Metodología de Calificación de Finanzas Corporativas (pub. 29 Dec 2022)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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

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