Research Update:

Ultrapar's Stand-Alone Credit Profile Cut To 'bbb-', Ratings On It And Raizen Affirmed Despite COVID-19 Shock

April 23, 2020

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Rating Action Overview

- Restrictions on movement to contain the spread of the virus have caused the demand for gasoline and ethanol, and to a lesser extent for diesel, to fall sharply.
- Lower volumes and fuel prices, and potentially weaker margins per cubic meter will increase leverage among the sector's players, but ratings on Ultrapar Participacoes S.A. (Ultrapar), and Raizen Combustiveis S.A. and Raizen Energia S.A. (jointly referred to as Raizen) have headroom to withstand the pernicious impacts.
- On April 23, 2020, S&P Global Ratings revised downward the stand-alone credit profile (SACP) of Ultrapar to 'bbb-' from 'bbb'. We also affirmed the global scale 'BB+' issuer credit and issue-level ratings and the national scale 'brAAA' rating. The outlook remains stable, and the global scale ratings remain capped up to two notches above the 'BB-' sovereign rating on Brazil.
- We also affirmed our 'BBB-' and 'brAAA' ratings on Raizen and kept its 'bbb' SACP unchanged. The outlook is still stable, and the global scale ratings remain capped up to three notches above the sovereign rating on Brazil.
- The stable outlooks reflects Ultrapar and Raizen's sound liquidity positions and cushion in ratings when compared to the final ratings amid sovereign ceilings.

COVID-19 will take a toll on fuel distribution volumes, but impact also depends on the companies' ability to maintain margins and business diversification. We believe that restrictions on movement in Brazil will cause a decline of 15%-20% in gasoline and ethanol volumes, 5%-10% in diesel, and 40%-50% in aviation fuel for 2020. Also, we expect a decline of 25%-35% in fuel prices at the pump, mirroring the sharply lower international oil prices, partly offset by the Brazilian real's depreciation while Petrobras maintains its pricing policy of international parity. These factors should reduce the fuel distribution sector's EBITDA by R$500 million – R$1 billion, given EBITDA per cubic meter close to R$95, lower than about R$100 in 2019. Margins will depend on pricing strategy in the next few quarters, which could offset short-term impact of higher inventory costs, and ability to maintain margin in a scenario of higher competition amid lower volumes. Both Raizen and Ultrapar have other businesses that should suffer less than the fuel distribution unit, partly offsetting its lower EBITDA.

Liquidity position are solid. We don't detect liquidity pressures on Raízen and Ultrapar's credit quality. Both companies maintain sound cash positions and smooth debt amortization profiles, and they enjoy sound bank relationships to access funding, if needed.

Rating Action Rationale

Ultrapar

The downward revision of Ultrapar's SACP reflects the persistently higher-than-expected leverage in 2019 and 2020, with debt to EBITDA above 3.0x and funds from operations (FFO) to debt below 30%. Nonetheless, the ratings at 'BB+' and 'brAAA' remain unchanged, because they remain capped at two notches above the sovereign rating. The lower EBITDA at its fuel distribution business should be partly offset by stronger results at its other units:

- We expect better margins at Oxiteno following cost reductions and operational adjustments at its U.S.-based plant, but they're subject to volatility in chemicals spreads;
- Ultracargo should post volume growth of 10%-15% thanks to greater capacity since the second half of 2019;
- We view Ultragaz's operations as resilient despite potentially lower volumes due to economic downturn; and
- We forecast Extrafarma to contribute R$50 million - R$100 million to total EBITDA, compared with R$27 million in 2019.

We expect consolidated debt to EBITDA in the 3.5x-4.0x range in 2020, but to drop closer to 3.0x in 2021. Also, we still expect FOCF despite the forecast of a likely sluggish economic recovery. In our view, Ultrapar's liquidity is not at risk, given that at the end of 2019, the company had a total short-term cash position of R$5.2 billion and short-term debt of R$1.3 billion. In addition, Ultrapar aims to reduce capex to R$1.2 billion in 2020 from the initial forecast of R$1.8 billion. This, despite the rising working capital, should result in FOCF of R$500 million – R$600 million. Also, the company has recently raised R$1.5 billion in short-term debt to strengthen its cash position amid current economic and industry uncertainties. Therefore, we expect cash sources over uses to remain above 2.0x in the next 12 months. Higher leverage might breach the 3.5x debt-to-EBITDA covenant in 2020, but it only applies to a portion of Ultrapar's debt (about R$2.8 billion). This amount consists of bilateral loans, and we expect the company to obtain waivers, if necessary.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety and consumer related factors.

Outlook

The stable outlook on Ultrapar reflects that on Brazil. Although we have revised downwards the company's SACP because of weaker-than-expected metrics in 2019 and 2020, the SACP is still higher than the global scale rating. We currently cap our global scale rating on Ultrapar up to two notches above the sovereign rating, because the fuel distribution business is strongly correlated to the country's economic performance.

Downside scenario

A downgrade of Ultrapar would occur if we were to take the same rating action on Brazil, or if we were to revise downward the company's SACP by two notches. The latter could stem from a steeper and broader impact from COVID-19 on Ultrapar's operations, along with consecutive quarters of strategic mistakes, leading to a lower market share, debt to EBITDA above 4.0x, and FFO to debt below 20% beyond 2021. This could also trigger a revision of Ultrapar's business risk profile to a weaker category because of persistently higher volatility in margins than those of peers.

We could also lower our ratings on Ultrapar if its liquidity position for the next 12 months deteriorates under the stress scenario test amid lower operating efficiency and lesser ability to refinance debt. In this scenario, we believe the company's ability to reduce investments and dividend distribution, as well as maintaining low short-term debt and high cash holdings, would diminish. Such a scenario could prompt us to lower the ratings on Ultrapar to the sovereign level.

Upside scenario

Absent any changes to Ultrapar's SACP, a positive rating action on Brazil could result in a similar action on the company. We don't believe an upward revision of the SACP is likely for the next 12-24 months, because it would require the leverage metric to be at historical levels, closer to 2x, and a track record of margin stability despite economic downturn.

Raízen

We currently expect Raízen's consolidated debt to EBITDA to remain fairly stable in fiscal 2021, in the 2.0x-2.5x range, while FOCF should be about R$1.5 billion, along with large cash balance and strong liquidity. While the strain on Raizen's fuel distribution business is similar to our view of the industry, which will experience a volume decline of 15%-20% and EBITDA per cubic meter closer to R$95 in 2020, EBITDA contribution from Raizen's sugar and ethanol (S&E) division should remain stable, at R$3.3 billion - R$3.5 billion before the IFRS16 adjustment. This is because Raízen has hedged most of its sugar volume at about R$61 per pound for the 2021 harvest that started on April 1, 2020, and it has the ability to hedge its ethanol, through a proxy hedge strategy with gasoline, diminishing the impact of the sharp drop of ethanol prices in the domestic market. Equally important, the negligible rise in leverage stems from a conservative financial policy, in our view, allowing Raizen to retain significant dividends amid the very uncertain scenario.

Working capital needs could be significant for Raízen, given the potential need to provide support to the supply chain under the currently stressful scenario. In the fuel distribution business, the company needs to create mechanisms to help the retailers. Also, in its S&E business, the company might need to provide some support to third-party sugarcane growers, which account for 50% of Raizen's supplies, and reference prices for which will decline because of lower spot prices for sugar and ethanol. In addition, the company would have to bear a significant amount of working capital to maintain ethanol and sugar inventories, although it's already part of the company's strategy.

We maintain our view of Raízen's liquidity position as strong. We estimate that, as of the end of March 2020, the cash position was R$7 billion – R$8 billion, given that Raizen should have sold most of its inventory held in December 2019. Also, the company has $1 billion in undrawn revolving credit facilities ($700 million from shareholders and $300 million from syndicated banks), and it doesn't have financial covenants on its debt, which strengthens its liquidity flexibility. These factors, along with FFO of R$5 billion, should help the company maintain cash sources over uses above 2x, even with capex estimated at R$3.7 billion and seasonal working capital of about R$2.4 billion for the next 12 months.

Outlook

The stable outlook on Raizen mirrors that on Brazil, and a rating action on the latter would trigger a similar action on the company. Our 'bbb' SACP on Raizen reflects our view of its ability to maintain debt to EBITDA in the 2.0x-2.5x range even amid the virus-induced economic shock. This is thanks to operating efficiency, hedging strategy, and conservative financial policy, holding off on dividend payments amid an unclear scenario.

Downside scenario

We could take a negative rating action on Raizen if we were to downgrade the sovereign, despite Raizen's higher SACP. We could revise downward Raizen's SACP in the next 24 months if EBITDA and cash flows deteriorate, raising debt to EBITDA above 3.0x and reducing FOCF to debt below 15%. Such a scenario could stem from the virus's longer-than-expected economic hit, causing a steeper decline in fuel distribution volumes and margins in the next 12 months, coupled with severe weather conditions and consistently low commodity prices, which would hinder cash flows and liquidity.

Upside scenario

We could take a positive rating action on Raizen on a similar action on Brazil. Although unlikely, we could revise upward Raizen's SACP in the next 24 months if debt to EBITDA and FFO to debt remain consistently close to 1.5x and 60%, respectively, even amid a weak commodity cycle. We would also need to see a longer track record of FOCF to debt remaining above 25%, with proven sustainability of its business even amid economic downturn.

Ratings Score Snapshot

Ultrapar

Issuer Credit Rating: BB+/Stable/--

brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Raízen

Issuer Credit Rating: BBB-/Stable/--

brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate

Issuers, Dec. 7, 2016

- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | Industrials: Key Credit Factors For The Agribusiness And Commodity Foods Industry, Jan. 29, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Raizen Combustiveis S.A.	
Raizen Energia S.A.	
Issuer Credit Rating	BBB-/Stable/--
Brazil National Scale	brAAA/Stable/--
Raizen Energia S.A.	
Senior Unsecured	brAAA
Raizen Fuels Finance S.A.	
Senior Unsecured	BBB-
Ratings Affirmed	
Ultrapar Participacoes S.A.	
Issuer Credit Rating	BB+/Stable/--
Brazil National Scale	brAAA/Stable/--
Ultrapar International S/A	
Senior Unsecured	BB+
Recovery Rating	3(55%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.