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Research Update:

Sao Martinho S.A. 'BB+' Global Scale And 'brAAA' National Scale Ratings Affirmed, Outlook Remains Positive

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Research Update:

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Overview

- Brazil-based sugarcane processor São Martinho (SMO) has posted rising cash flow generation and improved credit metrics despite global sugar prices volatility.
- We're affirming our 'BB+' global scale and 'brAAA' national scale ratings on the company.
- The positive outlook on the global scale rating indicates a potential upgrade in the next 12 months if São Martinho generates free operating cash flow (FOCF) while deleveraging, with adjusted debt to EBITDA consistently below 2x and FOCF to debt approaching 15%.

Rating Action

On Oct. 18, 2018, S&P Global Ratings affirmed its 'BB+' global scale and 'brAAA' national scale issuer credit ratings on São Martinho S.A. (SMO). We have maintained the positive outlook on the global scale rating and the stable outlook on the national scale rating.

Rationale

The global scale positive outlook reflects the company's performance alignment with our expectations, with rising FOCF after the full consolidation of Usina Boa Vista and solid operating efficiency, despite the weaker sugar prices. We will track SMO's ability to maintain this trend amid volatile exchange rates, less favorable weather conditions that reduced the harvest volumes, and the uncertainties over Petrobras' pricing policy for the gasoline, which could ultimately affect ethanol prices and overall profit for the sugarcane sector in the country. We can upgrade SMO to investment grade in the next 12 months if it continues to deleverage and generates solid FOCF, with a debt to EBITDA below 2x and FOCF to debt around 15%.

Over the past four years, SMO has generated FOCF and posted low earnings volatility thanks to its sound agricultural yields, larger scale, favorable locations of its mills, adequate investments in the fields, and hedging strategies. These factors have provided the company with resilient operating margins and a very competitive cash cost. SMO has also consistently improved its liquidity position with an extended debt maturity profile and higher cash position, despite the much larger working capital consumption in June 2018. The latter stemmed from holding larger ethanol inventories to sell in the off-season periods, when prices are usually higher.

The strength of SMO's business has helped offset the impact of sluggish international sugar prices as a result of the global output surplus, with India as the main driver. Global prices declined to around 10 cents per pound in August 2018 from above 20 cents per pound in October 2016, with current prices in the range of 12-13 cents per pound. Also, the solid operating efficiency and low leverage help SMO to navigate through periods of severe weather conditions and pricing downturns with resilient margins and credit metrics.

Our base-case forecast for the company considers a crushing volume of about 20.5 million tons of sugarcane in the 2018-2019 harvest and close to 21.5 million in the following one. Cash flow generation should remain strong, around R$480 million for the 2018-2019 harvest. This is despite weak international sugar prices because Brazil's depreciated currency and more attractive returns for the ethanol offset this impact. We don't incorporate any potential upside from RenovaBio program due to the uncertainties of its implementation and the lack of clarity over potential additional cash flow from the decarbonization credits (CBio). One of the main potential risks to our base-case scenario is Petrobras' shift away from its current pricing policy of gasoline aligned with international oil price, which could hamper ethanol's profitability.

We also include the following assumptions in our our base case:

- Brazil's GDP growth of 1.4% in 2018 and 2.2% in 2019, which affects ethanol consumption while sugar is more globally oriented;
- Inflation rate at 4.2% in Brazil in 2018 and 4.0% in 2019, impacting mainly labor-related expenses;

Exchange rate of R$4.00/$1.00 in 2018 and R$4.15/$1.00 in 2019;

- Average fixed VHP sugar price of about R$1,100 per ton in the 2018-2019 harvest and R$1,150 per ton in the 2019-2020 harvest, which incorporates what the company has already fixed and then follows the FX and NY11 curve;
- Average ethanol prices of R$1.85 per liter in fiscal 2019, increasing according to international Brent oil prices and average exchange rate over the next few years;
- Capital expenditures (capex) of R$1 billion per year; and
- Dividend payment of about R$180 million in fiscal 2019 and R$200 million in fiscal 2020.

Based on these assumptions, we reach the following credit metrics for the next two years:

- Adjusted EBITDA of about R$1.7 billion and R$1.9 billion in fiscals 2019 and 2020, respectively;

- FOCF of about R$480 million in fiscal 2019 and R$630 million in fiscal 2020;
- Debt to EBITDA of 1.5x-2.0x in fiscal 2019 and close to 1.5x in fiscal 2020;
- FFO to debt in the 45%-60% range in fiscals 2019 and 2020; and
- FOCF to debt close to 15% in fiscal 2019 and 20%-25% in fiscal 2020.

We continue to test SMO's ability to withstand a hypothetical default of Brazil to assess if its rating can stay above the 'BB-' sovereign rating. The company is able to pass the test thanks to the large share of its revenue coming from exports and its adequate liquidity. The strong export revenue, due to depreciation of the Brazilian real, offsets the impact of the sugar's weak price, inflation's impact on costs, and the currency depreciation effect on its short-term foreign currency debt position. We currently assess that the cap on SMO's rating is up to three notches above Brazil's foreign currency rating.

We incorporated the following assumptions for the stress test:

- GDP decline of 10% in fiscal 2020, impairing domestic ethanol sales, while sugar exports remain unchanged;
- Inflation at 12%, pressuring costs;
- Currency depreciation of 50%, doubling dollar-denominated debt, raising cash outflow for interest and short-term debt payments;
- Average sugar prices dropping to 9.5 cents per pound, but prices in reals benefit the currency's depreciation;
- Stable ethanol prices in domestic market (capped by 70% of gasoline prices) because we don't expect Petrobras will fully adjust prices to tame inflation;
- Interest rates doubling in Brazil;
- Minimal capex in stress scenario of R$630 million;
- No haircut in cash that the company holds outside the countries, a 10% haircut in bank deposits in Brazil, and 70% haircut in the short-term investments in Brazil;
- No dividend payments.

Liquidity

We maintain our view of SMO's liquidity as adequate, despite considerable improvements over the past few quarters. The sources over uses of cash should be close to 1.5x for the next 12 months and it will remain positive even if EBITDA declines 30%. SMO has reduced its short-term debt sharply while maintaining higher cash position. Liquidity profile will also benefit from the likely strong FOCF over the next few years. In our view, the company has an overall prudent risk management and a sound relationship with banks, which also support our liquidity assessment. We expect SMO to maintain comfortable cushion of above 50% for its covenant measurements of net debt to EBITDA below 4.0x.

Principal liquidity sources:

- Cash position of R$1.57 billion, as of June 2018; and
- Expected FFO generation of R$1.5 billion over the next 12 months.

Principal liquidity uses:

- Debt maturities of R$406 million, as of June 2018;
- Working capital outflows of R$51 million over the next 12 months and seasonal working capital requirement of R$400 million;
- Capex of R$1 billion over the next 12 months; and
- Dividend payments of about R$180 million over the next 12 months.

Outlook

The positive outlook reflects our expectation that SMO will maintain resilient credit metrics and solid FOCF generation, despite the sluggish sugar prices and severe weather conditions in the current harvest. This is thanks to the company's sound operating efficiency, conservative financial policy, and maintenance of adequate liquidity and low leverage amid a more supportive ethanol price scenario and depreciated currency.

Upside scenario

We could upgrade SMO in the next 12 months if it maintains the current conservative financial policy while generating resilient cash flows. We expect to see a longer track record of stronger metrics--with debt to EBITDA below 2.0x and FFO to debt above 45% on a consistent basis--a FOCF generation despite low prices for sugar and increasing uncertainties over the ethanol prices, resulting in a FOCF-to-debt ratio close to 15% in fiscal 2019 and above 15% afterwards. For an upgrade, we also expect the company to maintain its improved liquidity position, which has significantly strengthened in first quarter of 2019, with stronger cash position and extended debt maturity profile, allowing the company to continue passing our stress test to be rated above the sovereign rating on Brazil.

Downside scenario

We could revise the global scale rating outlook to stable if adverse climate conditions or a sharp decline in sugar and or ethanol prices weaken the company's FOCF generation, eroding its liquidity and credit metrics. In this scenario, SMO's adjusted debt to EBITDA and FFO to debt would approach 3x and 30%, respectively, while FOCF would be negligible. We could also take a negative rating action if SMO's liquidity position deteriorates, which could compromise its ability to pass the stress test to be rated above the sovereign, triggering a downgrade to the sovereign's level.

Ratings Score Snapshot

Corporate Credit Rating
Global Scale: BB+/Positive/--
Brazil National Scale: 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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: negative (less one notch)

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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 - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Sao Martinho S.A.	
Issuer Credit Rating	
Global Scale	BB+/Positive/--
Brazil National Scale	brAAA/Stable/--

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.

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