Research Update:

# Sao Martinho S.A. Upgraded To 'BBB-' From 'BB+' On Consistently Low Debt Levels; Outlook Stable

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## Rating Action Overview

- Brazil-based sugarcane processor, São Martinho S.A. (SMTO), has sustained solid operating efficiency and consistent free operating cash flow (FOCF) generation throughout industry cycles, even amid depressed sugar prices and less favorable weather conditions.
- We expect SMTO to keep its conservative debt profile, containing leverage and shareholders' remuneration while sustaining solid liquidity, underpinned by management's financial policies.
- On Oct. 23, 2019, S&P Global Ratings raised its long-term issuer credit rating on SMTO to 'BBB-' from 'BB+' on the global scale. It also affirmed the 'brAAA' national scale rating. The outlook on both scales is stable.
- The stable outlook reflects our expectation that SMTO will maintain its debt to EBITDA consistently below 2.0x, funds from operations (FFO) to debt above 45%, and FOCF to debt at about 10% - 15%, although the latter depends on investment decisions in a scenario of contained debt.

## Rating Action Rationale

The upgrade of SMTO primarily reflects the company's ability to generate consistently positive FOCF and sustain low leverage over the last several years, with proven resilience amid industry downturns. It also considers management's conservative financial policies and commitment to keep debt low, despite continued investments in projects that should further enhance SMTO's profitability and business resiliency in the long term. We estimate debt to EBITDA will remain consistently below 2x, underpinned by the company's public leverage targets.

The company's performance and leverage profile have been aligned with our expectations. SMTO was able to increase FOCF to about R$415 million in last fiscal year even amid weak global sugar prices of about $12-13 cents per pound. FOCF also grew despite challenging weather conditions that led to lower crushing volumes of 20.5 million tons of sugarcane in fiscal 2019 (ended March 31, 2019) versus 22 million in the previous fiscal year. These factors have resulted in debt to EBITDA consistently below 2x, FFO to debt above 45%, and FOCF/debt of about 14%. Although FOCF-to-debt and interest coverage ratios are somewhat lower than our previous expectations,

we predict that low cost of debt and increase in crushing volumes should result in SMTO's EBITDA interest coverage above 7x and FOCF to debt above 12% as of fiscal 2021 assuming no other large investment.

SMTO has a solid operating efficiency and very competitive cash cost of production within the sector, thanks to the extended average age of its fields with solid agricultural yields, reducing capital expenditures (capex) required per ton of sugarcane crushed; economies of scale in its large mill; efficient logistics; and favorable mill locations. Additionally, its flexibility allows it to optimize ethanol over sugar on up to 60% of production. These factors, along with its assertive hedging strategy and ability to combine scale with competitive cash cost, leads to significant potential cash flows.

### Further business growth, despite smaller scale and business diversification compared to peers with the same rating

The company's strong financial flexibility and comfortable liquidity allows SMTO to sustain high investments in long-term projects that should improve margins and its business resiliency. These projects include the COA project (agricultural automation), pre-sprouted seedlings, the MEIOSI planting system, and the expansion of its cogeneration assets with the recent sale of 177 GWh of energy through the A-6 auction. This energy contract has a 25-year tenor and will require investments of about R$320 million, and should add about R$20 million-R$30 million to its annual EBITDA starting in fiscal 2023.

The company also plans to build a new corn ethanol plant attached to its Usina boa Vista mill in the Brazilian state of Goias. This plant has a total estimated capex of R$350 million and will produce 200,000 cubic meters of ethanol, which is about 20% of SMTO's current production. We estimate that this plant is able to generate annual revenue of R$450 million-R$500 million and EBITDA of R$140 million-R$180 million. We don't include this plant in our base-case forecast because it still need the fiscal benefit confirmation and final shareholders' approval, but the impact to credit metrics wouldn't be meaningful during the investment phase of about 2.5 years.

### Neutral to positive credit impacts, but not fully incorporated.

We expect SMTO to maintain its dividend payout of 35% to 40% of the previous year's net income. We forecast that the company will fund additional shareholder remuneration with the cash proceeds of Copersucar legal claims (a lawsuit against the federal government on damages from the setting of sugar and ethanol prices in the 1980s). We expect the cash proceeds to SMTO from this lawsuit to amount close to R$150 million to R$200 million per year, over the next six years.

An additional source of cash could stem from the Renovabio program that will allow certified mills to issue Cbios (decarbonization credit certificates) as of 2020. The values for the certificates are uncertain, but we estimate it could add about R$50 million to SMTO's EBITDA.

## Outlook

The outlook is stable. We expect SMTO to maintain a solid operating performance in light of the continuous investments in its agricultural fields and new technologies that should improve EBITDA generation and soften the volatility inherent to the business. Additionally, our base case considers that SMTO will keep its conservative financial policy and solid liquidity position that allows it to withstand our sovereign default scenario.

We expect SMTO to keep its debt to EBITDA 1.5x-2.0x in fiscal 2020 and below 1.5x over the next few years. We forecast FOCF generation close to R$340 million in fiscals 2020 and 2021, sustaining FOCF to debt of 10%-15% despite some increase in capex.

### Downside scenario

We could take a negative rating action if severe adverse climate conditions or a sharp decline in ethanol prices amid still weak sugar prices weaken the company's FOCF generation, hurting its liquidity and credit metrics. This could also stem from a change in Petrobras' pricing policy, impairing ethanol's profitability. In this scenario, SMTO's adjusted debt to EBITDA and FFO to debt would be close to 3x and 30%, respectively, while FOCF would be negligible. We could also take a negative rating action if SMTO's liquidity position deteriorates, with significant currency mismatch or high working capital requirements, which could compromise its ability to pass the stress test to be rated above the sovereign, triggering a multiple notches of downgrade to the sovereign level. Likewise, a downgrade of the sovereign rating would trigger the same rating action on SMTO.

### Upside scenario

An upgrade is unlikely because the rating on SMTO is now at the maximum amount of notches it can be above the sovereign rating on Brazil. A stronger stand-alone credit profile (SACP) is unlikely in the next 12 to 24 months, mainly because it still lacks scale, geographic, and product diversification compared to companies with higher ratings. However, it could occur if SMTO continues to invest in growing its business while sustaining debt to EBITDA and FFO to debt consistently below 1.5x and above 60%, coupled with FOCF to debt above 25%. We would also expect SMTO to maintain its ability to be rated above the sovereign.

## Company Description

SMTO is one of the largest sugarcane processors in Brazil, with four sugarcane crushing mills. It has a crushing capacity of about 24 million ton per year, and in the last harvest it produced close to 1.0 million tons of sugar and 1.1 billion liters of ethanol. It also cogenerates energy, with a generation of close to 1 GWh per harvest year.

Sugar production is mainly destined for the export market, while its ethanol is driven by local demand of fuel for the domestic vehicle fleet.

## Our Base-Case Scenario

- Crushing volume of 22 million tons in fiscal 2020, 22.7 million tons in fiscal 2021, and 23.8 million tons in fiscal 2022.
- Brazil's GDP growth of 0.8% in 2019 and about 2.0% in 2020 and in 2021, affecting ethanol consumption while sugar demand is more globally oriented.
- Inflation rate of about 3.5% in 2019 and close to 4.0% in 2020 and 2021, influencing mainly labor expenses.
- Average foreign exchange (FX) rate of R$3.95 per $1 in 2019, about R$4.10 per $1 in 2020, and R$4.20 per $1 in 2021.
- Average VHP prices of R$1.180 per ton in fiscal 2020 and R$1.280 per ton in fiscal 2021.

- Average ethanol prices of R$1.80-R$1.90 per liter over the next two harvests, then increasing according to international Brent oil prices and average FX rate.
- Capex of about R$1.3 billion in fiscal 2020 and R$1.45 billion in fiscal 2021, not including the corn ethanol plant, but considering the expansion of cogeneration assets.
- Dividend payments and share repurchases of R$205 million in fiscal 2020 and R$330 million in fiscal 2021.
- Cash inflow from Copersucar legal claims of about R$150 million this fiscal year and R$200 million in the following.
- We include in our adjusted debt position the land leasing agreements. We don't adjust SMTO´s partnerships contracts due to our view of the contingent payment characteristics of those contracts, with shared risk between parties and no economic incentives for the company to cancel them.

Based on the assumptions above, we expect the following credit metrics:

- Adjusted EBITDA of about R$1.8 billion in fiscal 2020, R$2 billion in fiscal 2021, and R$2.1 billion in fiscal 2022;
- FOCF of about R$345 million in fiscal 2020 and fiscal 2021, and R$385 in fiscal 2022;
- Debt to EBITDA of 1.5x-2.0x in fiscal 2020 and in the 1.2x- 1.5x range after that;
- FFO to cash interest in the 6.0x-8.0x range over the next few years;
- FFO to debt of 50%-65% in fiscals 2020 and 2021; and
- FOCF to debt in the 10-15% range over the next few years.

## Liquidity

We view SMTO's liquidity as adequate. The sources over uses of cash ratio is 1.4x over the next 12 months and it would remain positive even if EBITDA declines 30%. The company has a large cash position and manageable debt maturity profile, with a low level of short-term maturities, which are most related to trade financing lines that are typically automatically renewed. We also expect the company to continue to generate strong FOCF over the next years, improving its liquidity position. We understand that the company has an overall prudent risk management and a sound relationship with banks, which also supports our liquidity assessment. We estimate SMTO will maintain over a 50% cushion on its covenant requirements.

### Principal Liquidity Sources:

- Cash position of R$2.1 billion as of June 2019; and
- Expected FFO generation of R$1.7 billion over the next 12 months.

### Principal Liquidity Uses:

- Debt maturities of R$1.0 billion as of June 2019;
- Working capital outflows of R$14 million over the next 12 months and seasonal working capital requirement of R$300 million;

- Total capex of R$1.35 billion over the next 12 months; and
- Dividend payments of about R$110 million over the next 12 months.

## Rating Above The Sovereign

We limit our ratings on SMTO up to three notches above our sovereign rating on Brazil (BB-/Stable/B) due to our assessment of the company's moderate sensitivity to country risk. We also limit it to one notch above Brazil's 'BB+' transfer and convertibility (T&C) assessment of because of the company's export nature, which balances the risk of its asset concentration in the country. Therefore, we continue to test SMTO's ability to withstand a hypothetical default of Brazil.

The company is able to pass the test thanks to the large share of its revenue coming from exports, very low exposure to short-term debt in foreign currency, and its high cash position. The strong export revenue, due to depreciation of the Brazilian real in the hypothetical scenario, offsets the impact of the weak sugar and ethanol prices, inflation's impact on costs, and the currency depreciation's effect on the short-term foreign currency debt.

We incorporated the following assumptions for the stress test:

- GDP decline of 10% in 2020, impairing domestic ethanol sales, while sugar exports remain unchanged;
- Inflation at 12%, pressuring costs;
- Currency depreciation of 50%, doubling dollar-denominated debt and raising cash outflow for interest and short-term debt payments;
- Average sugar prices dropping to 9.5 cents per pound, but prices in Brazilian reais benefiting from the currency 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$650 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; and
- No dividend payments.

## Ratings Score Snapshot

Issuer Credit Rating

Global Scale: BBB-/Stable/--

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: 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 | 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, 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

**Upgraded; Outlook Action**

| | To | From |
|---|---|---|
| **Sao Martinho S.A.** | | |
| **Issuer Credit Rating** | | |
| **Global Scale** | BBB-/Stable/-- | BB+/Positive/-- |
| **Rating Affirmed** | | |
| Sao Martinho S.A. | | |

| Issuer Credit Rating | |
|---|---|
| Brazil National Scale | brAAA/Stable/-- |

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