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13 August 2020

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RATINGS

**Empresas Publicas de Medellin E.S.P**

| | |
|---|---|
| LT Issuer Rating - Dom | Baa3 |
| Outlook | Negative |

*Source: Moody's Investors Service*

KEY METRICS:

**Empresas Publicas de Medellin E.S.P.[1]**

| | 2018 | 2019 | Mar-2020 |
|---|---|---|---|
| Debt / EBITDA | 4.5x | 3.4x | 3.8x |
| CFO pre WC / Debt | 18.7% | 18.4% | 18.9% |
| Interest Coverage | 3.5x | 4.6x | 4.5x |

*[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.*

*Source: Moody's Financial Metrics™*

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# Empresas Publicas de Medellin E.S.P

## Claims against Ituango contractors and resignation of the board are credit negative

On 11 August, Empresas Publicas de Medellin E.S.P. (EPM, Baa3 negative) announced the filing with the civil courts of the Department of Antiochia, a request for an out-of-court conciliation process with the consortium responsible for the construction of the Ituango dam and their insurance providers. Through such process, EPM seeks to recover damages incurred on the 2018 Ituango dam incident for approximately $2.6 billion. In April 2018, falling rock and soil blocked a tunnel and disrupted the downstream flow of water from Colombia's (Baa2 stable) Cauca River through the Ituango dam. The company, together with advisors and suppliers, continues to work on safety measures and the advance of construction. The announcement is credit negative as it increases the risk of further delays and cost overruns to complete the Ituango dam, depending on how the consortium responds.

That same day, EPM also announced the resignation of eight of its nine-member board of directors. The mayor of the City of Medellin (Baa2 stable), the board´s chairman remains as the only board member. The resignation of the board followed the holding of an extraordinary board meeting where the board expressed its dissatisfaction with ongoing efforts to modify a number of company bylaws and the lack of consultation prior to the decision to pursue damages against contractors. The abrupt resignation highlights the weaknesses within EPM's corporate governance structure.

EPM based its request for the extrajudicial process on the results of a report by Skava Consulting, an engineering consulting firm, identifying the root causes of the 2018 incident on the blocking of the diversion tunnel in April 2018 and subsequent events. The request envisions compensation to damaged machinery, additional financial costs, lost profits, and expenses related to compensation of the approximately 4,000 people affected. Under the process, a three month window to seek conciliation will begin. The company highlighted failure to reach an agreement within such time frame will likely start a period of stronger legal claims and dispute.

The timing to file the request follows EPM´s interpretation that damage claims need to be filed within a two-year window of the occurred event. We recognize the company's senior management's statutory obligation to pursue any potential compensation the company may be entitled to but we believe there are risks to further delays and cost overruns on Ituango depending on how the construction consortium responds. A potential replacement of construction contractors would lengthen the construction period and likely increase costs, and would be detrimental to EPM´s leverage trajectory further exposing the company ´s balance of risks. Even if successful, the process started by EPM will be protracted and probably not bring any benefit to the company within the horizon envisioned for the dam to reach operations in 2022.

The credit view continues to factor in EPM's guidance that 300MW (phase 1) of the total 2,200 MW of installed capacity will be in operations by early 2022, versus the initial schedule of late 2018, that it will receive insurance coverage proceeds related to damages of $500 - $550 million until the end of 2021, and that total capex for the Ituango Project will be of around $3.8 - $4.3 billion, which represents a 34% increase over the initial budget. The delays and cost overruns have led the company to be free cash flow negative for several years and delayed the company's deleveraging trajectory.

As to the board of directors resignation, we understand there has been no direct infringement of the company's bylaws or formal corporate governance structure. The company's Chief Executive Officer is responsible for representing the company judicially and extrajudicially, and the decision to pursue damages against the consortium of contractors was not up to the board of directors. Nonetheless, the board´s resignation exposes a fragile corporate governance structure under the 99.9% ownership by the Municipality of Medellin, and the company´s heightened exposure to political risks. In fact, the mayor holds ample power to nominate all remaining eight members of the board without major restrictions.

The weak board structure has been the same for several years, but in practice, and pursuant to a General Agreement for Corporate Governance in place since 2007, the Municipality has historically exercised its ownership power solely through the board of directors. These events may also pose challenges for EPM to assemble a new board of directors of high quality and credibility.

Headquartered in Medellin, Colombia, EPM is a multi-utility vertically integrated public service group operating in energy generation, distribution and transmission; natural gas distribution; water and sanitation; solid waste management; and telecommunications. For the 12 months ended March 2020, 75% of the company's EBITDA was derived from the electricity distribution (43%) and energy generation (32%) segments. The company benefits from 35 power generation plants with installed generation capacity of 3,584 MW. EPM also serves 6.6 million consumers in the distribution segment. Apart from providing its own services, the group also holds ownership stakes in controlled and noncontrolled subsidiaries located in Colombia and abroad (mainly Chile, Panama, El Salvador, Guatemala and Mexico).

EPM's credit quality reflects its large scale and consolidated revenue base diversified by sector, with the more stable electricity distribution business being the most important EBITDA contributor, with a share of 43% up until March 2020. We expect leverage to increase such that debt to EBITDA reaches 5.5x by year-end 2020, as a reflection of lower EBITDA generation and higher indebtedness to support liquidity. The reduction in EBITDA is a function of lower demand for services and rising costs amid weaker hydrology. We expect EBITDA and cash flow to resume strongly in 2021, reestablishing the deleveraging trajectory such that debt to EBITDA declines to approximately 4.0x by year-end.

## Moody's related publications

Credit Opinion: Empresas Publicas de Medellin E.S.P.: Update to credit analysis, March 2020

Empresas Publicas de Medellin E.S.P: Acquisition of CaribeMar to increase leverage in the medium term, March 2020

Empresas Publicas de Medellin E.S.P: Insurance recognition and asset sale are credit positive, September 2019

Empresas Publicas de Medellin E.S.P: Risks remain following successful closure of Ituango control gate, January 2019

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