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Research Update:

Interconexion Electrica S.A. E.S.P. Upgraded To 'BBB' From 'BBB-' On Improved Financial Performance; Outlook Stable

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Overview

- Our view of Colombia-based electricity transmission company ISA's financial performance has improved due to the stability and predictability of its cash flow stream, its position as a monopoly, and continued deleveraging trend, which continues to support our "intermediate" financial risk profile assessment.
- We are raising our corporate credit rating on ISA to 'BBB' from 'BBB-'.
- The stable outlook reflects our expectation that ISA's investment strategy will continue to boost profitability and its future expansion will not compromise the company's key financial ratios.

Rating Action

On Aug. 18, 2014, Standard & Poor's Ratings Services raised its corporate credit rating on Interconexión Eléctrica S.A. E.S.P. (ISA) to 'BBB' from 'BBB-'. The outlook is stable.

Rationale

The upgrade reflects the company's improved financial metrics, which has led us to revise ISA's stand-alone credit profile (SACP) to 'bbb'. Our view of its business risk profile continues to be "satisfactory" and its financial risk profile remains "intermediate."

The ratings on ISA continue to reflect the "low" likelihood that the government of Colombia (foreign currency: BBB/Stable/A-2; local currency: BBB+/Stable/A-2) would provide timely and sufficient extraordinary support to ISA in the event of financial distress.

ISA's "satisfactory" business risk profile reflects its "satisfactory" competitive position in Colombia, Brazil, Peru and Chile due to limited competitive pressures given the nature of the electric transmission business, and natural monopoly in ISA's business units. The company has adequate diversification as the largest energy transportation company in Colombia, which has national coverage. Given the enormous capital costs involved in building competing networks, we consider transmission as a natural monopoly. Additionally, the company has adequate operating efficiency based on its experience in building and operating transmission facilities, and the

economies of scale that it has developed, which allow it to secure new expansion bids. The ratings on ISA also reflect our view of Colombia's favorable institutional and regulatory framework, which contributes to the stability of the energy sector.

ISA's "intermediate" financial risk profile reflects the company's sufficient internal cash flow to fund its capital expenditures (capex) in Brazil and Colombia. We expect the company's credit metrics to improve in the next two years as it deleverages to a net debt to EBITDA of about 3.0x and FFO to debt of 23% in 2015. For 2014, we expect net debt to EBITDA to be about 3.2x, interest coverage to be 4.0x, and funds from operations (FFO) to increase to about Colombian peso (COP) 1.69 billion. As of June 30, 2014, adjusted net debt to EBITDA was 3.4x, FFO to debt was 23%, and debt to capital was 38%. Our rating on ISA incorporates our expectation that its Brazilian operations will continue to use the proceeds from the payments received from the Brazilian government, as a result of the implementation of Law 12,783/2013, to pay down its existing debt. ISA has prepaid Brazilian real (R\$) 437.2 million with the proceeds.

Our base case assumes:

- Revenue growth of 8% and 13% in 2014 and 2015;
- Gross margins of about 62% in 2014; and
- Capex according to ISA's investment plan.

Based on these assumptions, we arrive at the following credit measures for 2014 and 2015, respectively;

- Net debt to EBITDA of 3.2x and 3.0x; and
- FFO/Debt of 22% and 23%
- Interest coverage of 5.0x in both years.

The ratings also incorporate our assessment that there is a "low" likelihood that the Colombian government would provide timely support to ISA, if needed, because the company generates significant cash flow and debt outside of Colombia. As its primary shareholder, the Colombian government holds a 51.4% stake in ISA. However, based on our government-related entity criteria, we also assess ISA to have a limited link to the government, given the independence of its management and corporate practices.

Liquidity

We assess ISA's liquidity as "adequate." We expect sources to exceed uses by at least 1.2x in the next 12 months, which provides protection against adverse market conditions. We also expect sources to cover uses even if EBITDA were to decline by 15%. Additionally, our view reflects ISA's very good credit standing in the capital markets and with the local banks. We also include its flexibility with regard to capex and dividend payments in our analysis.

Principal Liquidity Sources

- Cash of about COP 1.91 billion as of June 30, 2014; and

- FFO generation of COP1.63 billion in 2014.

Principal Liquidity Uses

- Debt maturities of COP518 for the remainder of 2014;
- Working capital outflow for about COP150 million in 2014;
- Capex for about COP1.4 billion - COP1.7 billion in 2014; and
- A dividend payment of about COP690 billion in 2014.

Outlook

The stable outlook on electricity company ISA reflects our expectation that the company's key financial metrics will improve in 2014 and 2015.

Downside scenario

If ISA were to engage in heavily debt-financed acquisitions that weaken its financial risk profile, resulting in a consolidated net debt to EBITDA of more than 4.0x and FFO to debt lower than 20%, we could lower the rating.

Upside scenario

An improvement in our view of ISA's business risk profile, which could be triggered by an increase in its operating margin, or a financial profile above our expectations, for example, a consolidated FFO to total debt above 35% and total net debt to EBITDA of less than 2.5x, could lead to an upgrade.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Very low
- 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: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related government rating: BBB

Likelihood of government support: Low (no impact)

Related Criteria and Research

- The Credit Outlook On Colombian Electric Utilities Is Stable Amid A Market-Oriented Regulatory Framework, July 21, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings List

Upgraded

	To	From
Interconexion Electrica S.A. E.S.P. (ISA) Corporate Credit Rating	BBB/Stable/--	BBB-/Stable/--

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