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Research Update:

Odebrecht Engenharia e Construcao Downgraded To 'CCC+' From 'B-' On Unsustainable Long-Term Capital Structure

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Overview

- OEC's reputation has been severely hit by the ongoing corruption case, and the company is struggling to complete a business turnaround even after reaching the leniency agreement with the authorities.
- We are lowering our global scale corporate credit ratings on Brazil-based engineering and construction company to 'CCC+' from 'B-' and our national scale ratings to 'brCCC+/brC' from 'brB-/brC'. The downgrade reflects our view that the company's current capital structure might become unsustainable in the long run and that OEC's liquidity is constrained.
- The negative outlook reflects our expectation that in the absence of positive events, such as collection of overdue receivables, monetization of intercompany loans, and a business turnaround that enables the company to replenish backlog, OEC's strategic review could result in a mounting possibility of a proactive effort to restructure its debt obligations.

Rating Action

On April 18, 2017, S&P Global Ratings lowered its global scale corporate credit rating on Odebrecht Engenharia e Construção S.A. (OEC) to 'CCC+' from 'B-'. At the same time, we lowered our national scale corporate credit rating on the company to 'brCCC+/brC' from ' brB-/brC '. We also lowered our issue-level ratings on OEC's sister company, Odebrecht Finance Ltd. (OFL), to 'CCC+'. The '4' recovery rating on this debt, indicating our expectation that lenders would receive average (30%) recovery of their principal in the event of a payment default, remains unchanged. The outlook on the corporate credit ratings remains negative.

Rationale

The downgrade reflects the uncertainty regarding the sustainability of OEC's capital structure in the long term in the absence of positive credit events, including a quick recovery in its cash conversion cycle and collection of overdue receivables, the receiving of about $450 million in intercompany loans that OEC provided to its parent, Odebrecht S.A., and a business turnaround that enables the company to replenish its backlog. The Lava Jato corruption probe has impaired OEC's reputation. And even after signing the leniency agreement with Brazilian, the U.S., and Swiss authorities, OEC is struggling to close the investigation, which other countries in Latin America have begun.

In addition, the company's backlog is likely to shrink to about $17 billion at the end of 2016 as a result of the exclusion of some projects (mainly GSP) from $28.1 billion in 2015 and $33.9 billion in 2014.

Even though we acknowledge that OEC's bonds benefit from a long-term maturity profile (next principal bond maturity is April 2018 with an outstanding amount of R$500 million), which reduces the default risk in the short term, our concerns have risen over the company's cash drain and ability to restore a sustainable liquidity and cash generation in order to avoid a debt restructuring scenario. We also view that OEC is susceptible to a much more limited financial flexibility due to a higher scrutiny from its counterparties (including clients and lenders) and a weak standing in capital markets.

Under our base-case scenario for 2017, OEC would post leverage metrics that would require it to adjust its debt position to new business conditions. This is based in the following factors:

- A 20% reduction in OEC's revenue, not only due to a shrunken portfolio of projects but also due to the low economic growth in the main markets that Odebrecht operates, such as Brazil, Angola and Venezuela.
- No large additions to the company's backlog in 2017, which could further decrease to $12 billion - $15 billion.
- A 6.5%-8.0% EBITDA margin due to the project portfolio's current composition, with a slower pace of execution of projects with a higher risk-return equation, such as in Venezuela.
- We expect working capital management to recover somewhat, given a gradual collection of overdue receivables and the company's adjusted strategy to deliver projects whose cash conversion is less uncertain.
- Net debt to EBITDA above 7.5x by including the debt that OFL issued, which OEC guarantees. If we were also to include the litigation obligation as part of the leniency agreement (which is allocated at Odebrecht S.A., but the bulk of allegations relate OEC), net debt to EBITDA would exceed 10.0x.

Liquidity

We view OEC's liquidity as less than adequate. Even though we expect the company to post a sources-to-uses ratio above 1.2x in the next 12 months, the lower free operating cash flow (FOCF) and weak standing in capital markets, as seen in its bonds traded at 30%-35%, have hindered OEC's ability to withstand a significant, unforeseen liquidity event without the need to refinance its capital structure. In addition, the company's risk management is faltering, as seen in its intercompany loan of approximately $450 million to Odebrecht S.A. even under tough business conditions for OEC.

Principal Liquidity Sources:

- According to preliminary non-audited data, OEC closed 2016 with a $1.3 billion in cash position; and
- $120-$150 million in cash from operations (after interest and tax payments) for the next 12 months.

Principal Liquidity Uses:

- Debt maturities of about $220 million during 2017; and
- Annual capex of slightly less than $80 million.

OEC is not subjected to financial covenants on its outstanding obligations. However, it must release audited financial statements in 120 days after the end of the fiscal year according to OFL's bonds agreements (about $3 billion). If the company fails to provide this information, we believe the creditors have the right to ask for a notice of default. They could send such notice if they account for more than 25% of each notes' series, and debt acceleration could occur after 60 days of cure period. The company is working to release those financial statements as soon as possible, and we're not incorporating acceleration events in our base-case scenario, even though actual timing remains uncertain.

Outlook

The negative outlook reflects the difficult prospects for OEC's business and its weaker financial flexibility to deal with a significantly heavier capital structure. In our view, backlog deterioration, cash drains from its parent company, and the persistently weak working capital cycle are pointing to a potential debt restructuring in order to adjust it to OEC's forecasted smaller scale.

Downside scenario

We could lower the ratings in the next two quarters if OEC is unable to restore a solid cash cycle by collecting overdue receivables and/or if the expectation of receiving the intercompany loans from its parent doesn't materialize. We believe that in the absence of such positive events, debt restructuring is very likely. Any higher perceived risk related to the release of annual audited numbers and covenants breach could trigger a downgrade.

Upside scenario

An outlook revision to stable for the next 12 months would depend on a successful revamp of the company's business and for a consistent backlog replenishing. Those factors could lead to positive FOCF and a more favorable view on the company's liquidity.

Recovery Analysis

Key analytical factors

S&P Global Ratings has recovery ratings on OFL's senior unsecured notes, which OEC guarantees. Our hypothetical scenario assumes a default in 2017 due to a heavy working capital load and the company's inability to replenish backlog, which would undermine its cash flow generation and lead to a capital structure not consistent to the company's size. This scenario would reduce revenue and EBITDA to such degree that OEC would be unable to service its debt and access capital markets to refinance its debt maturities.

In a default, we expect OEC to reorganize rather than liquidate because of its sizable structure, expertize, and presence in various markets. We applied a 4.0x EBITDA multiple to an estimated distressed emergence EBITDA of about R$980 million to derive our estimate of gross recovery value at around R$4.0 billion. We then discount 5% of the gross value to account for administrative expenses to arrive at a net enterprise value (EV) of R$3.7 billion, which is finally distributed among each debt instrument, according to the structure of guarantees and subordination.

Simulated default assumptions

- Simulated year of default: 2017
- Jurisdiction: Brazil
- EBITDA at emergence: R$980 billion (sum of assumed maintenance capex, interest and debt payments at the year of default)
- Implied EV multiple: 4x, which is lower than the average 5.0x applicable to the industry given the company's high reputation damage and weaker business prospects relative to global peers
- Estimated gross EV at default: R$3.7 billion
- Pari passu ranking of the group's existing and future senior unsecured debt

Simplified waterfall

Gross EV: R$4.0 billion

- Administrative expenses: 5%
- Net value available to creditors: R$3.7 billion
- Unsecured debt claims totaling R$11.3 billion;
- Recovery expectation: 30%

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 07, 2016
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 01, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Downgraded

	To	From
Odebrecht Engenharia e Construcao S.A.		
Corporate Credit Rating		
Global Scale	CCC+/Negative/--	B-/Negative/--
Brazil National Scale	brCCC+/Negative/brC	brB-/Negative/brC
Odebrecht Finance Ltd.		
Senior Unsecured	CCC+	B-
Recovery Rating	4(30%)	4(45%)

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.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.