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Low Global Sugar Prices Sour Credit Prospects For European And Brazilian Producers

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The decline in sugar prices over the past year is putting pressure on the profitability and credit metrics of European and Brazilian sugar and ethanol producers, and is the main reason we consider prospects for the sector to be negative overall. Last year, sugar prices fell by about 30% in the EU and by around 20% on world markets (see chart 1), mainly due to an oversupply of production compared to fairly stable world demand.

Even though market forecaster Kingsman Platts predicts that world consumption of sugar could slightly outstrip production in 2015/2016--at 177.5 million tons produced versus 182.5 million tons consumed--prices continue to be low today because global sugar inventories are still high. We believe the falling trend in EU sugar prices additionally reflects the market's anticipation that EU production will increase substantially when regulators lift production quotas in October 2017.

Overview

- Low sugar prices are weighing on the profitability and credit prospects of sugar and ethanol producers in Europe and Brazil.
- For EU companies, the end of EU quotas on Sept. 30, 2017, will add additional price pressures and market competition.
- Currency-exchange movements and government measures are benefitting Brazilian producers, but weak productivity and restricted access to financing are major short-term risks.

Meanwhile, the price of ethanol, the biofuel produced mostly from wheat or sugarcane, is also in the doldrums in Europe (see chart 2) because of low oil prices and high inventories. Ethanol profits have improved somewhat in Brazil since 2014 on the back of a rise in gasoline prices and higher taxation of gasoline. However, we think this does not fully mitigate the negative effect of lower sugar prices on the profitability of local producers because inflation continues to pressure their operating costs while drought has weakened their operating efficiency. In addition, the devaluation of the local currency benefits exports but is taking a toll on dollarized capital structures.

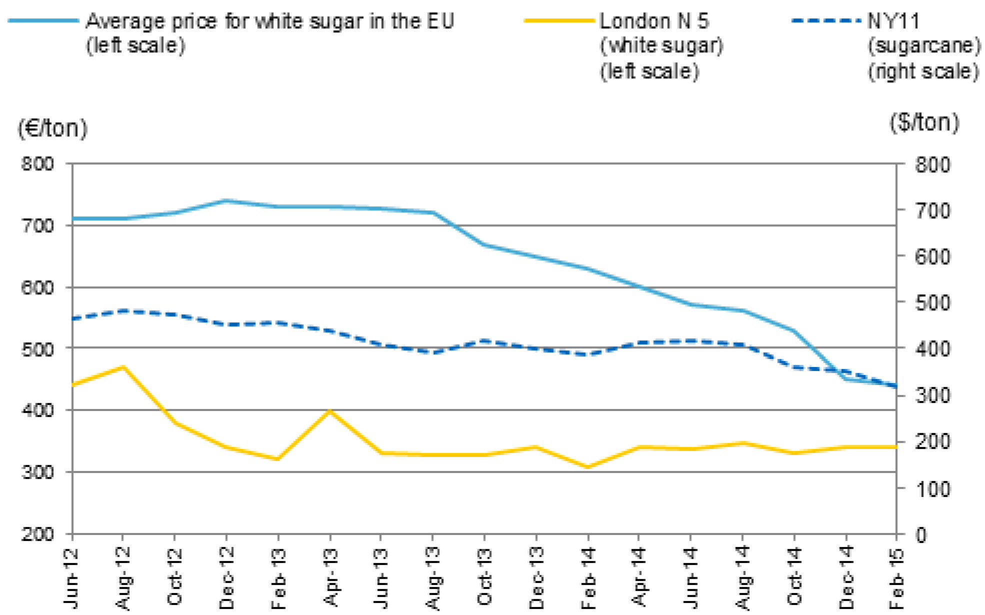
In our view, the main factors dragging on credit quality in the sector are producers' sharp revenue declines due to the drop in sugar prices, lower production volumes in Brazil because of the drought that has affected sugarcane harvests, and companies' inability to quickly adjust operating cost bases and cut large capital expenditures. In Brazil, these investments were partly debt financed, resulting often in highly leveraged capital structures. At the same time, working capital seasonality and capital intensity is high in this sector because companies need to invest continuously in their processing plants and equipment to ensure high productivity levels for upcoming harvests.

In light of these difficult conditions, we took a number of negative rating actions over the past months on companies in Europe and Brazil which we think have been the most affected by these trends. We revised the outlook to negative on EU-based sugar producers Tereos and Suedzucker in December 2014 and January 2015, respectively. We downgraded

Brazilian sugar and ethanol producers USJ Acucar and Usina Caete in November 2014, and additionally placed the latter on CreditWatch with negative implications in March 2015. We downgraded Virgolino de Oliveira to 'D' because the company missed an interest payment. We also withdrew our ratings on Aralco in March this year at the issuer's request after its default on bond interest payments earlier in 2014.

Chart 1

World Sugar Prices



Source: European Commision, Bloomberg.

Chart 2

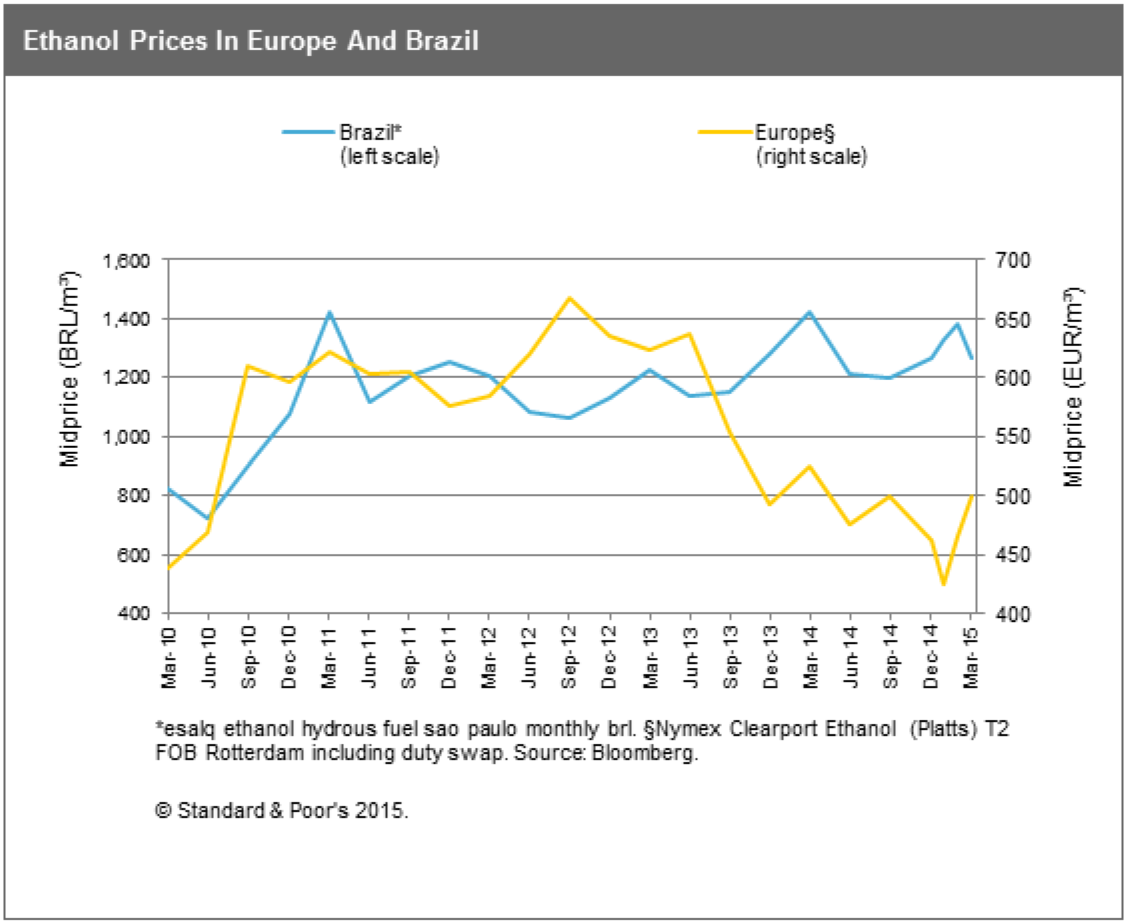


Table 1

Rated Sugar And Ethanol Producers In EU And Brazil

	Long-term Rating	Outlook	Business risk profile	Financial risk profile	Liquidity
EU					
Suedzucker AG	BBB	Negative	Satisfactory	Intermediate	Adequate
Tereos Union de Cooperatives Agricoles a Capital Variable	BB+	Negative	Satisfactory	Significant	Adequate
Brazil					
Raizen Combustiveis S.A.	BBB	Stable	Satisfactory	Intermediate	Adequate
Sao Martinho S.A.	BB+	Stable	Fair	Significant	Adequate
S.A. Usina Coruripe Acucar e Alcool	brA	Stable	Fair	Aggressive	Less than adequate
Jalles Machado S.A.	BB-	Stable	Fair	Aggressive	Less than adequate
USJ Açúcar e Álcool S/A	B+	Negative	Fair	Highly leveraged	Adequate
Usina Caete S.A. - NE	B+	WatchNeg	Weak	Aggressive	Less than adequate
Tonon Bioenergia S.A.	B	Stable	Weak	Highly leveraged	Less than adequate

Table 1

Rated Sugar And Ethanol Producers In EU And Brazil (cont.)					
Virgolino de Oliveira S.A. - Acucar e Alcool	D	--	Weak	Highly leveraged	Weak

Ratings and scores as of date of publication.

EU Sugar Producers Face Both Cyclical And Structural Constraints

In Europe--which produces around 10% of world's sugar, mostly sold within the European market--we believe that the profitability of sugarbeet processors is coming under pressure not only from the cyclical swings in prices, but also from structural changes in the industry, notably the end of EU quotas on Sept. 30, 2017.

The cyclical factors currently affecting prices in the EU are linked to high inventories and high production volumes expected in the region this year compared to relatively flat demand growth from industrial companies. Production volumes were boosted by a record harvest in 2014 driven by high agricultural yields and an increase in cultivated surfaces. Inventory levels remain high after four years of surplus production. Production volumes in the region could stabilize or slightly decline next year (2015/2016 harvest) as farmers plant fewer acres of sugar beet to adjust for lower prices and investments return.

Meanwhile, world sugar prices (which affect exports of European producers) could also stabilize in 2015 as a result of lower production in Brazil due to the drought in sugarcane plantations and growth in demand from emerging markets, notably Asia. The direction of the exchange rate between the Brazilian Real (Brazil is the world's largest producer and exporter) and the U.S. dollar (USD) will also remain an important factor.

Structural changes in our view include the end of quota restrictions in the EU after Sept. 30, 2017, and lower demand in the longer term from food & beverage industrials as regulation and consumer tastes on sugar consumption change. Today, the EU quota price is at an all-time low, at €433 per ton versus €632 per ton in 2006 (source: European Commission), year of the introduction of the quota system.

The end of EU quotas will have a significant impact on market dynamic for sugar producers. It will remove restrictions on production volumes and exports as well as on the minimum price paid to sugar beet farmers, while imports will still be regulated.

The second structural change, in our view, is that demand for white and brown sugar from food manufacturers in mature markets is likely to decline over time. Regulation on sugar content in food and beverages as well as changes in consumer tastes in favor of food products with low calorie content should hit long-term demand growth prospects in Europe and North America. Food and specialty ingredients manufacturers are already developing and using a large range of substitutes that can replace sugar in their products.

Brazilian Producers Lack Access To Financing And Face Weaker Productivity

Conditions may be improving for sugarcane processors in Brazil, which is the world's largest sugar producer and exporter responsible for almost 50% of global sugar trade. Brazil also has one of the largest domestic markets for ethanol worldwide.

Sugarcane production volumes have declined somewhat in past 12 months as of March 2015 (most of the crushing was already done in December) due to unfavorable weather conditions. The drought that affected the largest production area, the State of São Paulo, has led to lower yields on cultivated areas and reduced average capacity utilization rates in the plants.

The significant devaluation of the Brazilian real compared to U.S. dollar (down almost 30% in one year) has helped Brazilian sugar producers to sell more volumes on world markets without affecting their profitability too heavily. Although positive for revenue growth, credit metrics were negatively affected by the rise in dollar-denominated debt amid weaker profitability. Furthermore, about half of revenues come from the domestic market. Some Brazilian sugar processors with capacity to generate and sell excess energy produced in their boilers to third parties, also benefited from record-high spot energy prices in the country, which mitigated weak prices.

Demand for ethanol and market prices have been supported by recent government policies in Brazil, which raised gasoline prices in November 2014 and increased the mandatory blend rate of ethanol in gasoline to 27% versus 25% in March 2015. In order to be competitive, the Brazilian ethanol price is capped at a maximum 70% of the gasoline price. In recent years, gasoline prices had been maintained at a low level by the government, which reduced sugarcane processors' ability to improve prices. In addition, the drop in crude oil prices since November 2014 (when the latest gasoline price increase took place in the country) makes further gasoline price increases unlikely during this year.

We think the government measures, combined with a higher tax rate on gasoline, should support ethanol consumption and gradually improve profitability in Brazil. This ultimately should benefit the largest sugar processors, which can usually shift up to 15%-20% of their production between ethanol and sugar, depending on which product is more profitable for them.

A shorter term risk, which has become a reality in Brazil, is the lower availability of credit for sugarcane processors to roll over their debt maturities. This can limit their ability to adequately invest in plantations and meet their financial obligations. The cost of financing for corporates has risen due to a domestic interest rate at 12.75% and past issuances of dollar-denominated debt. In addition, recent defaults and debt restructurings in the sector have reduced investors' appetite for new debt issues. This can squeeze the liquidity position of corporates, which is a major concern for companies that Standard & Poor's rates in the 'B' category.

Financial Prospects For Rated Companies Are On The Downside

We do not foresee a significant improvement in profitability, cash flow generation, and credit metrics among the companies we rate in this sector over the coming 12 months. Low sugar prices and still high capital expenditures affect producers, while in Brazil higher refinancing risks and higher cost financing represent short-term risks for corporates (see charts 3 and 4).

Our main assumptions for over the next 12 months

Profitability:

- Renewal of sales contracts and hedging positions at current (lower) prices, which will dampen future revenues.
- Lower production volumes in Brazil and potentially also in Europe.
- Minimum payments to EU sugar beet farmers despite lower prices.
- Inflationary cost pressures in Brazil should hinder higher export revenues and EBITDA.
- Lower energy costs in Europe.
- A weak Brazilian real to the U.S. dollar should be supportive for Brazilian exporters because most operating costs are in local currency.

Working capital:

- The negative effect from current high inventory volumes should be offset by lower inventory costs. Players have increased inventories to await better future prices. Control over working capital expansion remains essential.
- Peak working capital in Europe is usually in February-March because processors pay sugar beet farmers in advance to enable them to sow the crops.
- Peak working capital in Brazil is September-December, when processors build up inventories for the 'off' season in January-March, when prices usually improve.

Capital expenditures (capex):

- Still large capex spending to expand and modernize production facilities.
- Still high capex in crop maintenance and renewal in Brazil.
- Expansion capex should reduce as producers have enough production capacities at current market prices and while Brazilian processors increase plants' utilization capacity.

Financing costs and debt:

- A continued decrease in the cost of financing for European producers, owing to low interest rates in the eurozone.
- A continued increase in the cost of funding in Brazil, with domestic interest at 12.75%. Together with higher risk aversion in the sector, this has increased interest burdens and investors' appetite to borrow (mainly following two defaults).
- A further increase in net debt levels due to lower free operating cash flow.
- In Brazil, the devaluation of the Brazilian real is affecting corporates' dollar-denominated debt, but should also help increase exports, with a fairly neutral effect on credit metrics, assuming a still stable currency-exchange rate.

Liquidity:

- We think the European sugar producers we rate can maintain "adequate" liquidity profiles, according to our criteria, owing to their good access to bank lending and manageable debt maturity profiles. We believe they can cut expansion capital expenditures and reduce price complements (the amount of payments above the minimum beet price made by processors to farmers) and dividend payments to protect financial covenant headroom.
- We consider Brazilian sugarcane processors rated 'B+' or lower exposed to the banks' willingness to roll over short-term debt, which mainly consists of working capital lines. However, the amount of debt to refinance has shrunk significantly as volumes have almost reached full capacity and capex is limited.

Chart 3

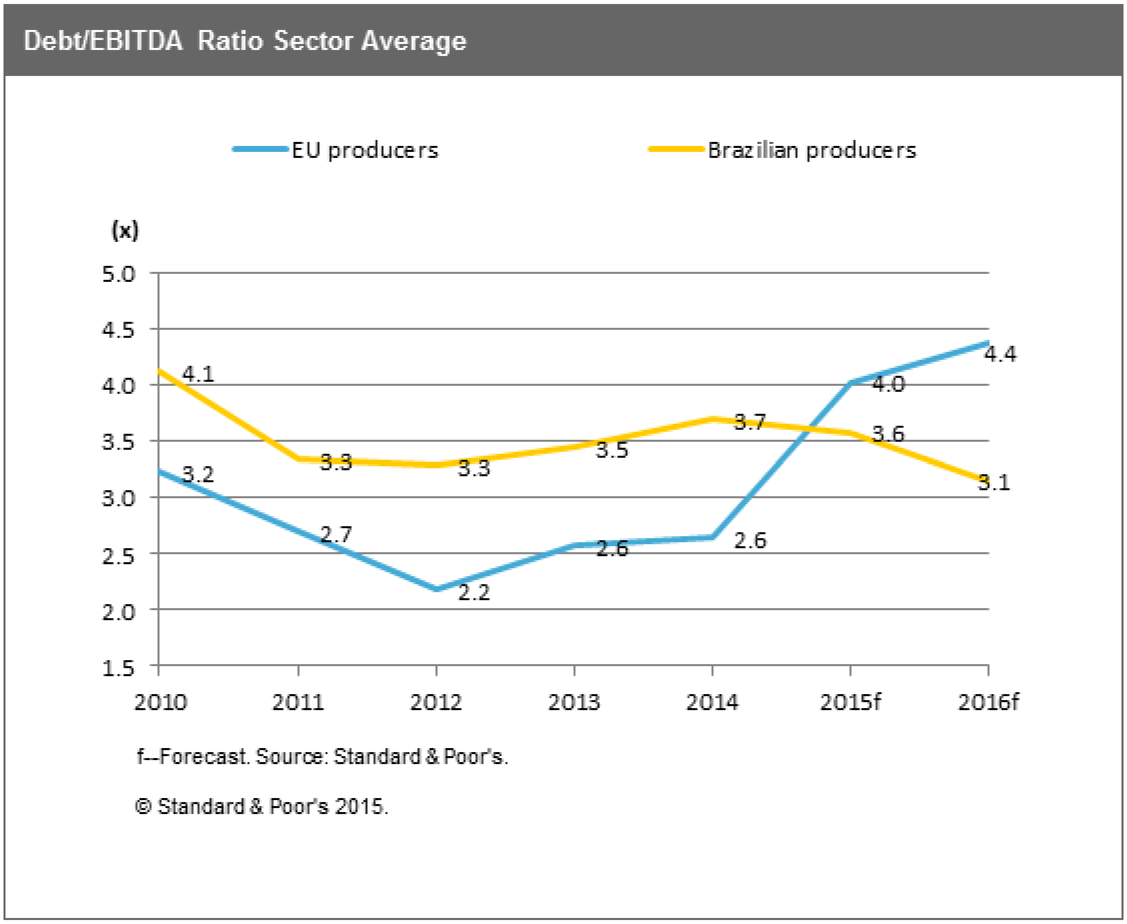
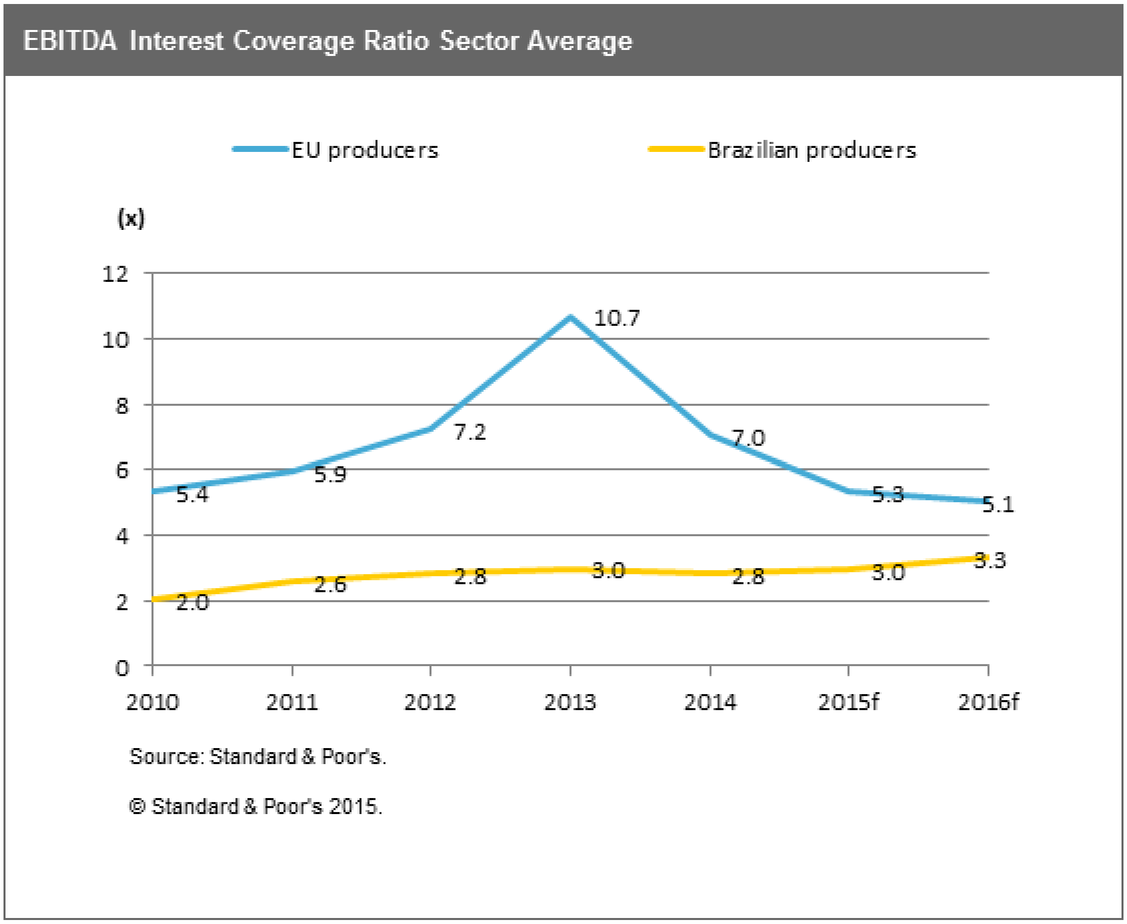

Debt/EBITDA Ratio Sector Average
EU producers
Brazilian producers
(x)
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
4.1
3.3
3.3
3.5
3.7
3.6
3.1
3.2
2.7
2.2
2.6
2.6
4.0
4.4
2010
2011
2012
2013
2014
2015f
2016f
f--Forecast. Source: Standard & Poor's.

Chart 4



EU And Brazilian Producers Face Tougher Future

Over the next few years, the EU sugar sector will likely face greater competition and continued price volatility. For ethanol producers, unless oil prices rebound sharply, the absence of new EU incentives on the demand side is unlikely to improve demand supply trends in the market. Post September 2017, EU producers are likely to substantially increase production volumes, which could lead to some oversupply and pressure on sugar prices in the region. The ability to increase sales to emerging markets, notably Asia, will be therefore be key for producers to maintain good operating efficiency and stable profitability. We think this could be difficult for the small players in the industry to achieve, and may lead to a higher concentration of firms in the sector. Companies could generate additional income by diversifying away from commoditized products into food production, specialty ingredients, or in energy cogeneration. Operating margins in these segments can be higher, and are historically less volatile than in sugar and ethanol. However, this is also a competitive market with higher research and development spending needs.

EU producers will need to continue reducing their operating costs if they want to remain profitable at current selling prices (we don't think that EU prices will return to the high levels of 2012-2013). Apart from maintaining a high capacity utilization rate and being more energy-efficient in their plants, discussions between sugar producers and farmers to agree on a lower price for sugar beet supplies will be important. We think discussions could prove more difficult in agricultural cooperatives, where suppliers (the beet farmers) are also members (shareholders) of the company.

In Brazil, we think sugar and ethanol producers will generate lower cash flows in the longer term as a result of low sugar prices, higher interest costs, and limited access to financing. This will mainly affect small players, which form the bulk of this large and very fragmented market. This could restrict overall sector production capacity in Brazil and may ultimately support global sugar prices through lower volume output. Weak global prices, low productivity levels, and inflationary input costs will likely lead to lower sugarcane production, which will consequently maintain the profitability of players with stronger operating efficiency. It will require that producers have new and healthy sugarcane plantations, economies of scale in sugarcane sourcing and plant production capacity, as well as efficient logistics for exports to reach ports.

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