

Rating Action: Moody's downgrades Embraer to Ba1; outlook negative

Global Credit Research - 25 Feb 2016

New York, February 25, 2016 -- Moody's Investors Service (Moody's) has today downgraded to Ba1 from Baa3 the foreign currency senior unsecured notes issued by Embraer S.A., Embraer Oversees Limited and Embraer Netherlands Finance BV. At the same time, Moody's withdrawn Embraer S.A.'s Baa3 domestic currency issuer ratings and assigned a Ba1 corporate family rating to the company. The outlook for all ratings remains negative.

The rating action follows Moody's downgrade on February 24, 2016 of Brazil's government bond rating to Ba2 from Baa3. In addition to downgrading Brazil's government bond rating, Moody's also downgraded the country's senior unsecured debt rating to Ba2 from Baa3, and the senior unsecured shelf rating to (P)Ba2 from (P)Baa3. The outlook was changed to negative. The rating agency also changed Brazil's country ceiling that went to Ba1 from Baa2. This rating action concludes the review for downgrade initiated on December 09, 2015. Please see "Moody's downgrades Brazil's issuer and bond ratings to Ba2 with a negative outlook" on moodys.com for more information.

Ratings downgraded:

- Issuer: Embraer S.A.
- USD 500 million senior unsecured notes due 2022: to Ba1 from Baa3 (foreign currency)
- Embraer Overseas Limited
- USD 23.6 million Backed senior unsecured notes due 2017: to Ba1 from Baa3 (foreign currency)
- USD 162.8 million Backed senior unsecured notes due 2020: to Ba1 from Baa3 (foreign currency)
- USD 540.5 million Backed senior unsecured notes due 2023: to Ba1 from Baa3 (foreign currency)
- Embraer Netherlands Finance BV
- USD 1,000 million Backed senior unsecured notes due 2025: to Ba1 from Baa3 (foreign currency)

Rating withdrawn:

- Issuer: Embraer S.A.
- Issuer Rating: Baa3

Rating assigned:

- Issuer: Embraer S.A.
- Corporate Family Rating: Ba1

The outlook on all ratings is negative.

RATINGS RATIONALE

"The downgrade of Embraer's ratings to Ba1 was prompted by Moody's decision to downgrade Brazil's government bond rating to Ba2 from Baa3." Explained Cristiane Spercel, a Moody's Vice President - Senior Analyst.

"Embraer's Ba1 rating now ranks one-notch above Brazil's government bond rating of Ba2, which is granted only on an exceptional basis for issuers that are fundamentally stronger than the sovereign. In the case of Embraer, this is evidenced by its significant revenue diversification, strong liquidity and limited exposure to devaluation of local currency through revenues generated outside of Brazil, which are sufficient to service its near-term debt servicing obligations. These factors outweigh Embraer's close links with the Brazilian economy and the local

government." added Cristiane.

Embraer's rating is constrained by Brazil's sovereign rating given that 50% of the company's fixed assets are domiciled in this country, and its internal production supports 72% of the consolidated revenues. As such, Embraer is directly and indirectly dependent on the country's economic deterioration and factors such as interest rates, inflation, along with tax payments and regulation at home. The company also has an exposure to the Brazilian Federal government (6% to 10% of the company's revenues) that is subject to budget constraints and fiscal availability. The company has been already experiencing delays in the recovery of receivables and margin losses in defense and security with the Brazilian Air Force since 2014. Additionally, Embraer has historically relied on funding from Brazilian public banks to support exports to clients and its investment plan, which currently represent 15% of its total liabilities outstanding. Mitigating the country risk is Embraer's natural hedge position as an exporter, with close to 90% of revenues from clients outside Brazil.

The Ba1 rating is supported by Embraer's leading position in the global market of regional jets, with a solid track record of control over operating costs and inventory management, which sustain healthy operating cash flows and strong financial metrics. Moreover, the company benefits from a positive industry outlook for the airspace and defense businesses and a healthy firm order backlog that supports almost 4 years of future revenues.

On the other hand, the cyclical nature of the aviation business and its growing competitive pressures also constrain Embraer's rating, because it requires significant investments on an ongoing basis to keep up with evolving customer needs. Working capital pressures and large capital expenditures will remain high through 2018, potentially reducing its liquidity cushion and increasing refinancing pressure over the next two years. In the absence of ample financing sourcing within the country, Embraer would be much more dependent on external banking financing and capital markets for liability management.

Nevertheless, we still see Embraer's strong liquidity cushion today as an important factor underpinning its Ba1 rating, given the aforementioned working capital pressures and large capital expenditures through 2018. The company has consistently maintained a high level of cash balances approximating the level of its outstanding debt. At the end of September 2015, the company's cash-on-hand and short-term investments of BRL9.8 billion (USD2.5 billion) approximated 70% of total adjusted debt and 2.5 times debt maturities through 2017. In June 2015, the company executed an anticipated liability management strategy with the issue of 10-year USD1.0 billion senior unsecured notes, and effective interest rate at 5.05% per year. As such, Debt to EBITDA leverage has spiked to 6.7x, but we expect it return to more normalized levels of 3.0x - 3.5x in 2016 and 2017.

The negative rating outlook factors our expectation that Embraer's free cash flow (cash flow from operations after capex and dividend payments) will remain negative at least until 2018 due to the ongoing investments for commercial jet development coupled with some pricing pressures. Additionally, Embraer's working capital requirements may increase in the near term with challenges on its domestic exposure in the defense and security business, along with potential tax increases and/or reduction of fiscal incentives on production arising from the country's economic distress.

The rating could be further downgraded in view of Brazil's sovereign rating deterioration or a deterioration in Embraer's liquidity position, for example by an increase to larger net debt position, without expectation of improvement in the near term. The rating would also be subject to negative pressure in view of weaker operating performance, such that adjusted Debt to EBITDA remains above 4.0 times (6.7 times in LTM 3Q15) and EBIT to Interest is below 2.0 times (2.2 times in LTM 3Q15). Industrial inefficiencies in production, insufficient mitigation of foreign exchange risk and/or any adverse development(s) with respect to the ongoing investigation by the SEC into possible violations of the Foreign Corrupt Practices Act, could also pressure the rating.

A higher rating is unlikely at this time, but it could be considered if Embraer manages to sustain its leading position in the competitive regional jets market while maintaining healthy revenue growth and operating profit margins, so that its adjusted Debt to EBITDA is less than 3.0 times and its EBIT to Interest is above 3.0 times, along with strong positive free cash flow generation (BRL300 million negative in LTM3Q15, after dividend payments). Maintenance of a strong cash cushion to support near term debt service and working capital needs also remains an important factor for any prospective rating improvement. A higher rating would be also dependent on Brazil's sovereign ratings, so that the difference between the two ratings is not larger than one notch.

The principal methodology used in these ratings was Global Aerospace and Defense Industry published in April 2014. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

Headquartered in Sao Jose dos Campos, Brazil, Embraer is the leading manufacturer of regional jet airplanes (generally, up to 120 seats), with a growing defense & security segment and a line of business jets including new

types for the mid-light and mid-size segments. In the last twelve months that ended September 30, 2015, Embraer generated approximately BRL17.6 billion (USD5.9 billion) in net revenues and BRL2.1 billion (USD700 million) in EBITDA. Founded in 1969 by the Brazilian federal government, the company was privatized in 1994 and transformed into a publicly-held corporation, subject to the provisions of Brazilian Corporate Law.

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