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Research Update:

Embraer S.A. 'BBB' Rating Affirmed; Off Watch, Outlook Negative, Reflecting Outlook On Brazil

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Overview

- Embraer continues to present strong financial metrics supported by its fairly stable cash generation and low debt levels. However, the company's manufacturing concentration in Brazil exposes it to the risks of doing business out of that jurisdiction, including transfer and convertibility (T&C) threats to its export-oriented business.
- We are affirming our 'BBB' ratings on Embraer and removing all ratings from CreditWatch with negative implications.
- The negative outlook reflects the fact that a negative rating action on the sovereign rating on Brazil would trigger a downgrade of Embraer.

Rating Action

On April 19, 2016, Standard & Poor's Ratings Services affirmed its 'BBB' ratings on Embraer S.A. and removed all ratings from CreditWatch. At the same time, we affirmed the 'BBB' issue level ratings on the senior unsecured debt issued by Embraer's financing subsidiaries, Embraer Overseas Ltd. and Embraer Netherlands Finance BV, which are fully and unconditionally guaranteed by Embraer. The outlook on the corporate credit ratings is negative.

Rationale

The ratings on Embraer reflect the company's strong market position as a reflection of its efficient product portfolio, which has resulted in improving contracted backlog while the company develops new products in the commercial, executive, and defense segments. Nonetheless, the majority of Embraer's operations are concentrated in Brazil, where the production of its commercial, defense, and part of its executive aircrafts are located.

As a result, we test whether Embraer can be rated above the sovereign rating on Brazil (BB/Negative/B) and the transfer and convertibility (T&C) assessment of the country (BBB-), given that under a sovereign stress scenario, it is likely the company would have restrictions to exchange money into hard currency and repay foreign currency debt and to pay its suppliers. Embraer comfortably passes the stress test, thanks to its sizable cash position held outside Brazil and low debt levels. Given the fact that Embraer generates most of its revenues through exports, and that demand is primarily generated by the global aviation market, we consider Embraer to have a moderate sensitivity risk to a default of the sovereign, which could allow its ratings to be up to four notches above the sovereign foreign currency ratings. However, given that less than 30% of the company's total revenues are generated outside of Brazil (either the plant in Florida, or through other services provided abroad), we have limited the rating on the company to one notch above Brazil's 'BBB-' T&C assessment, which is currently the main driver of the company's negative outlook.

We run a stress test on Embraer to assess the company's liquidity in a scenario of sovereign default, including T&C restrictions. In our test, we apply the following assumptions:

- GDP decline in Brazil of 10% in the stress year;
- Exchange rate of R$8.6 per $1 at the end of the year, and average of R$6 in the stress year;
- Inflation rates of 15% in the stress year;
- 100% decline in revenues from Brazilian clients, reflecting budget cuts from military orders, and no existing financing for airline and executive aircraft clients;
- 20% decline in commercial aircraft deliveries reflecting difficulties importing components and labor related issues;
- 25% decline in executive aircraft deliveries, as most of the production would be concentrated in Florida, with no disruptions to component imports;
- As a result, we expect a decline of Embraer's EBITDA of about 20%, and a 50% decline in funds from operations (FFO);
- We apply a 70% haircut to the company's cash position in Brazil (or about 32% of the company's total cash position), to reflect difficulties in accessing resources in local banks;
- The company's cash position outside of Brazil would be fully available; and
- Only about 25% of the company's export cash flows would be available for foreign debt repayments as a result of repatriation requirements.

Under our base case scenario, we expect Embraer to continue benefitting from more-efficient products than its competitors in commercial aviation in the next few years, mainly for aircraft with 70 to 130 seats, as new developments have a long-term maturity in this industry. This will allow Embraer to maintain its dominant market share of new aircraft deliveries in that segment. We expect the company to maintain fairly stable cash generation over the next two years, while it concludes the development of its new aircraft, the E2-190.

Embraer is also expected to further ramp up production of executive jets at its new facility in Florida, which should support greater sales volumes in this segment over the coming years. In the defense segment, we expect the company to remain on track with the development of currently contracted programs, which should contribute fairly stable and predictable cash flows over the coming quarters, although with some potential volatility in revenues due to delays in payments from the Brazilian government. Nonetheless, once the development of the KC-390 is concluded, the company could potentially benefit from greater sales volumes to international clients.

As a result of Embraer's currently strong competitive advantages, the company has been able to maintain a fairly stable order backlog of about $22 billion, which adds stability to the company's cash flows. In addition, given Embraer's track record of efficiently developing its programs with no major delay issues, in our base-case scenario we expect the company to generate strong enough cash flows to allow the company to finance its investments with internal cash generation, while paying debt maturities with its robust cash position. We expect Embraer to continue presenting strong leverage metrics and improving interest coverage ratios over the next few years, as the company pays down debt. In our base-case scenario, we also include the following assumptions:

- GDP decline in Brazil of 3.6% in 2016, and an increase of 0.5% in 2017;
- GDP growth in the U.S. of 2.8% in 2016 and 2017;
- GDP growth in the Eurozone of 1.5% in 2016 and 1.6% in 2017;
- Average exchange rates of R$4.2 per $1 in 2016 and R$4.5/$1 in 2017;
- Inflation rates of 7.5% in 2016 and 6% in 2017
- Exchange rates affect part of the cost base that is denominated in Brazilian real, more-than-compensating for the expected inflation rates.
- Aircraft delivery schedule in line with the company's guidance of about 105 commercial aircraft and 130 executive jets in 2016, and 100 and 140, respectively, in 2017;
- About $50 million of research expenses for the next 2 years;
- Capex plan of $675 million in 2016 and $650 million in 2017; and
- Dividend distribution of 25% payout.

As a result of these assumptions, we reach the following credit metrics:

- Revenues of about $6.1 billion in 2016 and $6.4 billion in 2017
- EBITDA of $750 million in 2016 and $820 million in 2017
- FFO of $600 million in 2016 and $670 million in 2017
- Debt to EBITDA around 1.0x in 2016 and 2017;
- FFO to debt above 85% in 2016 and above 100% in 2017;
- Slightly positive FOCF in 2016, but improving to about $80 million in 2017.

The combination of a satisfactory business risk profile and a modest financial risk profile results in a 'bbb+' anchor. In the case of Embraer, we believe that the company has a somewhat smaller scale of operations and a concentration of revenues among fewer aircraft models in the commercial aviation segment (relative to its larger global peers). Furthermore, the company is currently executing the development of two large aircraft programs, which can add volatility to credit metrics, especially if the Brazilian government delays payments of defense projects. For these reasons, we deduct one notch from the company's anchor by using a negative comparable rating analysis to reach the 'BBB' rating.

Liquidity

We continue to see Embraer's liquidity as exceptional. The company maintains a robust cash position in order to prepare for debt repayments as they come due over the next few years, and to avoid volatility of debt cost. As a result, the company's cash position of about $3.5 billion (including long term financial investments) corresponds to the same amount of Embraer's unadjusted gross debt. We also expect the company to be able to meet its capex needs mainly using its internal cash generation. Embraer is subject to financial covenants under some of its loan contracts that require the maintenance of less than 3.5x its net debt to EBITDA and interest coverage greater than 2.25x, and we expect the company to meet those covenants with significant headroom.

Principal Liquidity Sources:
- Cash position of $3.5 billion as of December 2015
- Annual FFO of $580 million in 2016 and $650 million in 2017
- About $100 million working capital gains in 2016

Principal Liquidity Uses:
- Debt maturities of $219 million in 2016 and $424 million in 2017
- Total investment plan of $675 million in 2016, and $650 million in 2017
- Dividend distribution of 25% payout

Outlook

The negative outlook reflects that on the sovereign rating on Brazil. A downgrade of Embraer would follow a similar rating action on the sovereign rating or T&C assessment, as we cap the ratings on Embraer at a maximum of one notch above the T&C on Brazil. Also, we could downgrade the ratings if operating performance weakens, either due to production issues, government payment delays, or weaker market conditions that weaken credit metrics, such as debt to EBITDA consistently above 2.0x, and FFO to debt below 45% over the next 12 to 18 months.

Upside scenario

An upgrade is unlikely at this moment since the rating is restricted to one notch above the T&C assessment on Brazil. We would revise the outlook to stable following similar action on the sovereign rating of Brazil.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Negative/--

Business risk: Satisfactory
- Country risk: Moderately High
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers:
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Unfavorable (-1 notch)

Related Criteria And Research

Related Criteria

- Key Credit Factors For The Aerospace And Defense Industry, March 25, 2014
- Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Ratings Above The Sovereign—Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Embraer S.A.		
Corporate Credit Rating	BBB/Negative/--	BBB/Watch Neg/--
Senior Unsecured	BBB	BBB/Watch Neg
Embraer Netherlands Finance BV		
Senior Unsecured	BBB	BBB/Watch Neg
Embraer Overseas Ltd.		
Senior Unsecured	BBB	BBB/Watch Neg

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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.