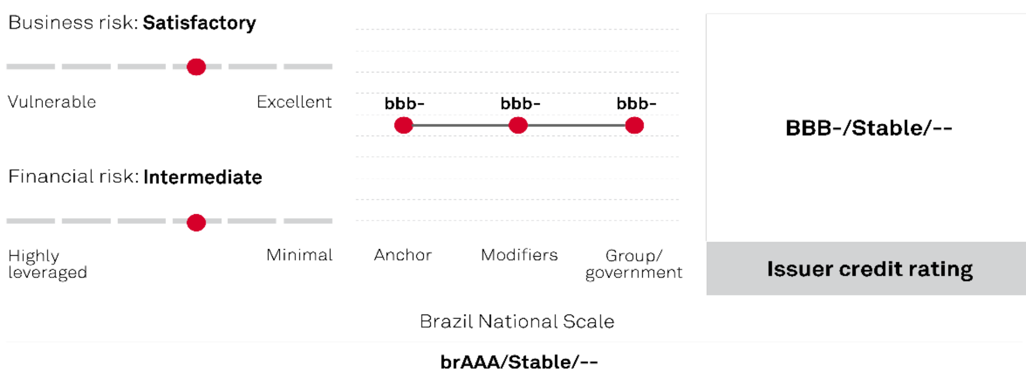
Sao Martinho S.A.

July 5, 2023

Ratings Score Snapshot



Primary contact

Bruno Matelli
Sao Paulo
55-11-3039-9762
bruno.matelli
@spglobal.com

Secondary contact

Flavia M Bedran
Sao Paulo
55-11-3039-9758
flavia.bedran
@spglobal.com

Credit Highlights

Overview

Key strengths	Key risks
Large scale of operations in four mills, combined with a competitive cash cost of production and flexibility between sugar and ethanol	Exposure to the factors that make the sugar and ethanol industry volatile, including commodity prices, weather, and foreign exchange rates
Conservative financial policy, historically maintaining debt to EBITDA below 2.0x	Capital-intensive business, with seasonally high working capital needs to carry inventories and sizable, recurrent capex
Adequate liquidity, with a solid enough cash position and cash generation to cover high capital expenditures and working capital requirements	The stand-alone credit profile is as high as it can be above the sovereign rating on Brazil
Ongoing investments to maintain benchmark operating performance and enhance mix flexibility	

Record-high sugar prices in Brazilian reals and lower idle capacity offset ethanol headwinds. Sao Martinho S.A. (SMTO) crushed 20.0 million tons of sugarcane in the fiscal year ended March 31, 2023, a slight increase from the 19.9 million tons it crushed in the previous harvest, when it confronted severe drought and frosts that damaged the plantations. We expect the recovery in cane availability to pick up this harvest season because of the rain during the off-season and at the beginning of the current harvest. SMTO should crush 21.5 million tons of sugarcane this year, which would mean less idle capacity--SMTO's crushing capacity is more than 24.5 million tons--and a dilution of fixed costs.

Sugar prices have spiked in recent months given the persistently tight supply-and-demand balance globally. The company still has about 30% of its output for the current harvest unhedged, meaning it will benefit from high spot prices that are reaching 2,700-2,800 Brazilian reals (R$) per ton despite recent currency depreciation.

Ethanol prices, however, are facing headwinds. On March 1, 2023, Brazil's new administration resumed the federal PIS/COFINS tax of R$0.47 and R$0.02 per liter for gasoline and ethanol, respectively, restoring the previous price differential between the two fuels in favor of ethanol. In addition, starting on June 1, 2023, the new ad rem (charged on a fixed value in reals)--as opposed to the old ad valorem (charged on a variable value in percentages)--state-level ICMS tax on gasoline rose to R$1.22 per liter versus the previous average of R$0.99 per liter. But a lower expected Brent oil price than in the previous fiscal year (at an average of $85 versus over $90) should more than offset the effect of the resumed taxes on gasoline prices, while the new Petroleo Brasileiro S.A. - Petrobras pricing policy, while still adhering somewhat to international parity prices, has resulted in reductions in gasoline prices. Therefore, we expect average ethanol prices in fiscal 2024 to decline by about 10% from the previous fiscal year.

The company’s new corn ethanol mill also began operations last March, and that should enhance diversification of raw materials, adding about 200,000 cubic meters of ethanol to the consolidated figures when the mill reaches full capacity by fiscal 2025--it should produce about 160,000 cubic meters of ethanol in the current fiscal year. And so we expect SMTO’s EBITDA to increase to almost R$3.8 billion in the current fiscal year, from R$3.5 billion in fiscal 2023.

Leverage has been stable despite lower free operating cash flow (FOCF) in fiscal 2023. SMTO has concluded its main expansion projects: the corn ethanol plant and the second phase of its energy cogeneration capacity in the São Martinho mill. The company will now focus on increasing its sugar and anhydrous ethanol output while it also studies the feasibility of potentially investing in a biogas plant. However, a portion of its sugarcane planting was delayed because of the rain that fell during the previous off-season, which, together with higher maintenance capex, means that consolidated investments for fiscal 2024 will decrease only slightly, to R$2.5 billion from R$2.6 billion in fiscal 2023. Given the higher working capital needed to build up corn inventories, FOCF was neutral in fiscal 2023. In spite of that, leverage remained fairly stable at 1.3x in fiscal 2023 versus 1.2x in fiscal 2022 and should remain below 1.5x over the next few years.

The company has a conservative financial policy and healthy liquidity. SMTO has maintained a conservative financial policy regarding shareholders' remuneration and investments, as well as financial policies with low exposure to foreign exchange rate swings on its debts. It also has a solid liquidity position, keeping a cash position equal to 2x-3x its short-term debt maturities. The company has access to long-term funding from bilateral lenders and capital markets, having secured funding for its investments from the Brazilian Development Bank (BNDES) and the International Finance Corp. (IFC), and it has also issued a green infrastructure debenture of R$1.1 billion. This should provide a comfortable cushion should market conditions worsen.

Outlook

The stable outlook reflects higher crushing levels and sugar prices that will support higher EBITDA despite somewhat lower ethanol prices. This, coupled with a decrease in capex (as the investments in the corn ethanol plant and energy cogeneration capacity are mostly complete), should increase FOCF. In addition, SMTO's liquidity should remain solid, allowing us to rate SMTO above the sovereign and enabling the company to withstand our stress test under a hypothetical sovereign default scenario. We expect adjusted debt to EBITDA of 1.0x-1.5x over the next few years and positive FOCF, even after taking the expansion capex into account.

Downside scenario

We could take a negative rating action if a long stretch of bad weather leads to consecutive crop losses amid lower ethanol and sugar prices. That, in turn, would bring about a FOCF shortfall and weaker liquidity. In this scenario, SMTO's adjusted debt to EBITDA would approach 3.0x and funds from operations (FFO) to debt would be close to 30%.

We could also take a negative rating action if SMTO's liquidity worsens, with significant currency mismatch or high working capital and capex requirements. That could jeopardize its ability to pass the stress test to be rated above the sovereign and could trigger a multiple-notch downgrade to match the sovereign rating.

In addition, a downgrade of the sovereign would trigger the same rating action on SMTO.

Upside scenario

An upgrade is unlikely because, although metrics are strong (with debt to EBITDA below 1.5x and FFO to debt above 60%), we believe that SMTO still lacks the scale and the geographic and product diversification of its higher-rated peers. The rating on SMTO is also as high as it can be above the rating on Brazil.

Our Base-Case Scenario

Assumptions

- GDP growth in Brazil of 1.7% in 2023 and 1.5% in 2024
- Inflation in Brazil of 5.2% in 2023 and 4.2% in 2024
- Average exchange rate of R$5.10-R$5.30 per US$1
- Average very high polarized (VHP) sugar price of R$2,400 per ton in fiscal 2024 and R$2,500 per ton in fiscal 2025
- Ethanol prices at R$3.10 per liter in fiscal 2024 and fiscal 2025, reflecting international oil prices and foreign exchange rates (assuming Petrobras will maintain a degree of correlation to the international parity)
- Crushing volume of 21.5 million tons in fiscal 2024, 22.1 million tons in fiscal 2025, and 22.7 million tons in fiscal 2026 (compared with 20 million tons in fiscal 2023)
- Corn processing volume of 415,000 tons in fiscal 2024 and 495,000 tons in fiscal 2025 (leading to 160,000 cubic meters and 200,000 cubic meters of ethanol production in each of those years)
- Dried distiller grains (DDG) production of 130,000 tons in fiscal 2024 and 150,000 tons in fiscal 2025
- Corn oil production of 6,600 tons in fiscal 2024 and 8,000 tons in fiscal 2025
- Corn prices at the mill of R$55-R$60 per bag (reflecting the logistics discount in the state of Goiás)
- Capex of R$2.5 billion in fiscal 2024 and R$2.4 billion in fiscal 2025, incorporating higher maintenance and crop treatment requirements
- Dividend payments of R$400 million-R$500 million per year in fiscal 2024 and fiscal 2025
- Net cash inflow from Copersucar's legal claims of about R$200 million in fiscal 2024 and R$150 million in fiscal 2025

Key metrics

Sao Martinho S.A.--Forecast Summary

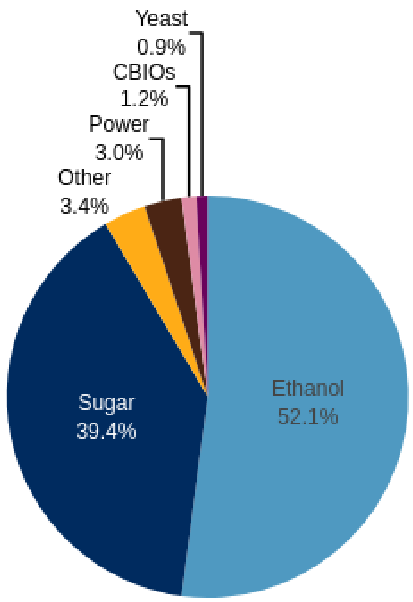
Fiscal year ended/ending	March 31, 2020	March 31, 2021	March 31, 2022	March 31, 2023	March 31, 2024	March 31, 2025	March 31, 2026	March 31, 2027
(Mil. R$)	2020a	2021a	2022a	2023a	2024e	2025f	2026f	2027f
Revenue	3,694	4,305	5,720	6,627	7,336	7,789	8,113	8,336
EBITDA	1,901	2,261	3,201	3,490	3,771	4.027	4,215	4,332
Funds from operations (FFO)	1,704	2,018	2,971	3,118	3,034	3,383	3,646	3,764
Capital expenditures	1,385	1,508	2,472	2,571	2,471	2,400	2,524	2,630
Free operating cash flow (FOCF)	366	279	576	2	228	688	813	821
Dividends	230	188	808	376	508	402	464	510
Discretionary cash flow (DCF)	61	82	(231)	(373)	(280)	286	349	312
Adjusted ratios								
Debt/EBITDA (x)	1.8	1.5	1.2	1.3	1.3	1.3	1.3	1.3
FFO/debt (%)	48.9	60.4	80.2	70.9	60.8	66.3	68.7	67.9
FOCF/debt (%)	10.5	8.3	15.6	0.1	4.6	13.5	15.3	14.8
DCF/debt (%)	1.8	2.5	(6.2)	(8.5)	(5.6)	5.6	6.6	5.6

All figures are adjusted by S&P Global Ratings unless stated as reported. a--Actual. e--Estimate. f--Forecast. R$--Brazilian real.

Company Description

SMTO is a Brazilian company that produces sugar, ethanol, and electricity through sugarcane crushing. Its sugar output is primarily directed to the export market, while the ethanol output is mainly bound for the Brazilian market, though ethanol exports are growing. SMTO is one of the largest sugarcane crushers in Brazil, operating four mills with a total crushing capacity of 24.5 million tons per year; the company effectively crushed 20.0 million tons of sugarcane and produced almost 1.4 million tons of sugar and 950,000 cubic meters of ethanol in the last harvest. The company also started operations at a corn ethanol plant that should crush almost 500,000 tons once it is operating at full capacity. SMTO's revenue was R$6.6 billion in fiscal 2023, and its EBITDA was R$3.5 billion. SMTO is controlled by the family-owned holding company LJN Participações S.A., which holds almost 54% of its shares. It's a public company with stock traded on the São Paulo Stock Exchange.

Sao Martinho S.A.--Net revenue breakdown as of March 31, 2023



Note: CBIOs are decarbonization credits. Source: Sao Martinho S.A.'s 2023 annual report.

Peer Comparison

SMTO is comparable with the sugar and ethanol operations of Raizen S.A., as well as with Adecoagro S.A. and Suedzucker AG. SMTO's operating efficiency compares favorably with Raízen because of the latter's lagging agricultural productivity and high idle capacity, but SMTO is only about one-fourth of the size of Raízen. While SMTO has been investing in corn ethanol and energy cogeneration, Raízen has been focused on second-generation ethanol. SMTO's leverage has historically been somewhat lower, but both companies are benefiting from higher sugar prices. That said, headwinds in ethanol prices tend to affect SMTO more because it's more exposed to the domestic market--Raízen produces more industrial ethanol and has increased exports with higher premiums.

SMTO’s sugar and ethanol business is larger than that of Adecoagro, but the latter also has sizable grain and dairy operations in Argentina along with its three mills with 13 million tons of crushing capacity in Brazil. Adecoagro’s cash costs were affected by the drought and frosts in Brazil, but the company is investing to return to near full capacity this harvest season while its Argentine crop operations are grappling with the severe drought there.

Suedzucker is more diverse in terms of geography and portfolio (including food, beverages, and ingredients), but it has a higher cash cost of production. And while it benefits from higher sugar prices and demand for ethanol in Europe, it is also more leveraged than SMTO.

Sao Martinho S.A.--Peer Comparisons

	Sao Martinho S.A.	Adecoagro S.A.	Raizen S.A.	Suedzucker AG
Foreign currency issuer credit rating	BBB-/Stable/--	BB/Stable/--	BBB-/Positive/--	BBB-/Positive/A-3
Local currency issuer credit rating	BBB-/Stable/--	BB/Stable/--	BBB-/Positive/--	BBB-/Positive/A-3
Period	Annual	Annual	Annual	Annual
Period ending	2023-03-31	2022-12-31	2023-03-31	2023-02-28
Mil.	R$	R$	R$	R$
Revenue	6,628	7,002	245,832	52,781
EBITDA	3,490	2,990	12,954	6,132
Funds from operations (FFO)	3,119	2,711	8,019	5,283
Interest	622	265	3,856	348
Cash interest paid	311	237	3,805	211
Operating cash flow (OCF)	2,573	2,149	12,198	1,306
Capital expenditure	2,571	1,602	11,426	2,221
Free operating cash flow (FOCF)	2	548	772	(914)
Discretionary cash flow (DCF)	(374)	166	(1,851)	(1,673)
Cash and short-term investments	3,078	1,219	8,742	2,230
Gross available cash	3,117	1,219	8,777	2,230
Debt	4,397	5,895	31,345	14,889
Equity	5,912	6,152	22,904	21,518
EBITDA margin (%)	52.7	42.7	5.3	11.6
Return on capital (%)	17.4	15.1	9.4	12.0
EBITDA interest coverage (x)	5.6	11.3	3.4	17.6
FFO cash interest coverage (x)	11.0	12.4	3.1	26.0
Debt/EBITDA (x)	1.3	2.0	2.4	2.4
FFO/debt (%)	70.9	46.0	25.6	35.5
OCF/debt (%)	58.5	36.5	38.9	8.8
FOCF/debt (%)	0.1	9.3	2.5	(6.1)
DCF/debt (%)	(8.5)	2.8	(5.9)	(11.2)

Liquidity

We view SMTO's liquidity as adequate. Sources of cash in the 12 months after March 31, 2023, should stay above 1.2x uses of cash. The company keeps a large cash position and smooth debt maturity profile, with short-term maturities being mostly related to trade finance lines that are typically renewed automatically, which are more than enough to cover both the company's sizable capex and its robust regular and seasonal working capital requirements. We understand that SMTO has prudent risk management overall and a sound relationship with banks; both support our liquidity assessment.

Principal liquidity sources

- Cash position of R$3.1 billion as of March 31, 2023
- Expected FFO of R$2.7 billion over the next 12 months

Principal liquidity uses

- Debt maturities of R$1 billion as of March 31, 2023
- Working capital outflows of about R$500 million over the next 12 months and seasonal working capital requirements of about R$450 million
- Maintenance and expansion capex of R$2.5 billion over the next 12 months
- Minimum dividend payments of about R$250 million over the next 12 months

Covenant Analysis

Requirements

SMTO has debt payment acceleration covenants on its loans from BNDES and IFC that are measured quarterly. The covenants require it to keep net debt to EBITDA below 3.0x and 4.0x, respectively. The debentures also have a 4.0x net-debt-to-EBITDA covenant.

Compliance expectations

We estimate that SMTO will maintain over a 70% cushion on its most restrictive covenant requirements (that it keep net debt to EBITDA below 3.0x).

Environmental, Social, And Governance

ESG Credit Indicators

E-1	E-2	**E-3**	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

Environmental	Social	Governance
- Physical risks	- N/A	- N/A

N/A--Not applicable. ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicator Definitions And Applications," published Oct. 13, 2021.

Environmental factors are a moderately negative consideration in our credit rating analysis of SMTO. Its exposure to environmental risk factors is in line with that of the Brazilian sugar and ethanol industry, with climate events--particularly droughts--that erode crop yields. For example, the severe drought in Brazil in 2021 slashed SMTO's sugarcane crushing volume to less than 20 million tons from 22.5 million tons in the previous harvest. Mitigating factors are SMTO's large scale, given that it's one of the five largest sugarcane crushers in Brazil; its efficiency, because it has one of the most competitive cash cost operations; and its portfolio of four plants. These factors, along with current ethanol and sugar prices, bolster SMTO's profitability. The drought's impact was more severe in the state of São Paulo; the company's operations in the state of Goiás were affected to a lesser extent. At the same time, the sector is key to transitioning to a low-carbon economy because it produces renewable energy--ethanol and electricity through bagasse-fired boilers--helping to replace fossil fuels and significantly reduce greenhouse gas emissions. The sector also benefits from a government program, Renovabio, in which the mills can issue CBIOs (decarbonization credits) according to the amount of ethanol produced.

Rating Above The Sovereign

We limit our ratings on SMTO to three notches above our sovereign rating on Brazil (BB-/Positive/B) owing to our assessment that the company has moderate sensitivity to country risk. We also limit our ratings on SMTO to one notch above the 'BB+' transfer and convertibility (T&C) assessment on Brazil because of the company's export nature, which balances the risk of its asset concentration in the country. We continue to test SMTO's ability to withstand a hypothetical default of Brazil.

The company passes that test thanks to the large share of its revenue that comes from exports, its very low exposure to short-term debt in foreign currency, and its sizable cash position. Strong export revenue (which is boosted in the hypothetical scenario by depreciation of the Brazilian real) offsets the effect of weak sugar and ethanol prices, the effect of inflation on costs, and the effect of currency depreciation on short-term foreign currency debt.

We incorporated the following assumptions into our stress test:

- A GDP contraction of 10% in the next 12 months;
- Inflation at 15%, pressuring costs;
- Currency depreciation of 50% (doubling the value of dollar-denominated debt and prompting larger cash outflows for interest and short-term debt payments);
- An average sugar price of 10 cents per pound (weighed down by potential export duties but boosted in Brazilian real terms by that currency's depreciation);
- No adjustment to the price of ethanol by international parity due to potential lower demand;
- Maintenance capex of R$1.3 billion;
- No haircut for cash that SMTO holds outside Brazil;
- A 10% haircut for bank deposits in Brazil; and
- A 70% haircut for short-term investments in Brazil.

Issue Ratings--Subordination Risk Analysis

Capital structure

As of March 31, 2023, SMTO’s debt consists of BNDES loans (about R$1.1 billion), IFC loans (almost R$800 million), agribusiness receivable certificates (about R$1.5 billion), debentures (about R$2.2 billion), rural loans (a little more than R$400 million), and export prepayments known as PPEs (almost R$600 million).

Analytical conclusions

We rate SMTO’s local senior unsecured debentures at the same level as the national scale issuer credit rating (brAAA) because all of the company's debts are issued at the operating company level and only 17% of its total debt is guaranteed by real assets.

Rating Component Scores

Foreign currency issuer credit rating	**BBB-/Stable/--**
Local currency issuer credit rating	**BBB-/Stable/--**
Business risk	**Satisfactory**
Country risk	Moderately High
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk	**Intermediate**
Cash flow/leverage	Intermediate
Anchor	**bbb-**
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	**bbb-**

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings Detail (as of July 05, 2023)*

Sao Martinho S.A.		
Issuer Credit Rating		BBB-/Stable/--
Brazil National Scale		brAAA/Stable/--
Senior Unsecured		
Brazil National Scale		brAAA
Issuer Credit Ratings History		
23-Oct-2019		BBB-/Stable/--
24-Oct-2017		BB+/Positive/--
22-Dec-2011		BB+/Stable/--
16-Aug-2017	*Brazil National Scale*	brAAA/Stable/--
22-Dec-2011		brAA+/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.