Research Update:

Frontera Generation Holdings LLC Debt Rating Lowered To 'CCC' On Near-Term Liquidity Risk; Outlook Negative

September 21, 2020

Rating Action Overview

- We are lowering our rating on Frontera's debt to 'CCC' from 'BB-' due to abrupt declines in operating cash flows stemming from the consequences of the COVID-19 pandemic and near-term liquidity risks. We are revising the recovery rating to '2' from '1'. We now expect a recovery of about 70% based on an earlier default year and weaker power prices for the next several years.
- Frontera Generation Holdings LLC is a 526-megawatt (MW) gas-fired combined-cycle generation plant in Mission, Texas, and is the only U.S. power plant that sells all its power to Mexico. Frontera typically benefits from higher spark-spreads than projects selling energy in the U.S., but the COVID-19 fallout hurt energy revenues in the entire Mexican market significantly and caused demand destruction in the first half of 2020.
- Realized power prices in the first-half 2020 were more than 50% below those for the same period last year. As of today, the project's revolving facility is 100% drawn, and there is risk it might not generate sufficient operating cash flows to pay debt service early next year if power prices do not recover substantially after the summer period. The project also has a quarterly 1.05x debt service coverage ratio (DSCR) test, triggered when more than 35% of its revolving facility is drawn, which is the case now.
- The negative outlook reflects our view that a debt service nonpayment situation could develop in early 2021 absent a material improvement in power prices and operating cash flows or a capital contribution from its sponsor Blackstone.

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Rating Action Rationale

Our rating action reflects our view that Frontera could face a liquidity crisis and risk nonpayment if power prices do not recover materially within the next few months. Moreover, it might need support from its sponsor to meet its upcoming debt service payments beginning in 2021.

We previously lowered our rating on Frontera's debt to 'BB-' from 'BB' in May 2020, because it materially underperformed our debt paydown expectations, which we consider key for projects with a term loan B structures (that rely on cash flow sweeps) to reach the refinancing date with a sustainable capital structure. However, we expected the project's financial performance would be adequate in 2020 (but it was even weaker than in 2019 due to COVID-19-related demand reduction that reduced power prices).

The lack of a forward hedging market and price discovery in Mexico leaves the project vulnerable to high volatility that have been exacerbated by COVID-19-related demand declines (around 10% decline between April and June). Second quarter 2020 results were much lower than expected, with realized power prices about 70% below those of the second quarter of 2019 ($15.6 per megawatt hour (MWh) versus previous $50.7/MWh). This resulted in EBITDA generation of less than $1 million, compared to $30.5 million EBITDA generation in the second quarter of 2019.

Additionally, we note that EBITDA generation in the fourth quarter of 2019 was around $10 million, so fourth quarter 2020 results could be weaker considering the current market environment with weaker demand. Moreover, as of today, the project has fully drawn its $35 million revolving facility. If the revolving facility remains more than 35% drawn by the end of the quarter, it will activate the 1.05x financial covenant. We note however that the project has the ability to repay part of the revolver before Sept. 30 and draw funds again in October if needed.

Frontera's debt maturity schedule is as follows:

- Debt amortization payment of $1.9 million on Sept. 30 2020
- Interest service payment of around $11.1 million on Oct. 19 2020.
- Debt amortization payment of $1.9 million on Dec. 30 2020.
- Interest service payment of around $11 million on Jan. 19 2020.

While we forecast third quarter performance will be stronger than the second quarter and cash may be enough to cover the September and October debt service, we believe the project could face a liquidity crisis requiring external funding (such as a contribution from its sponsor) to pay debt service if power prices, which are typically higher in the summer months, do not recover substantially by the fourth quarter.

Outlook

The outlook is negative, reflecting that, in our view, the project is vulnerable to a covenant breach and liquidity crises in the upcoming six months, exposing it to an event of default if power prices do not recover materially in the remaining part of the year or the sponsor or another party does not inject capital into the project.

Downside scenario

We could lower the rating on the project's debt if we believe a default or distressed exchange appears to be inevitable within six months, absent unanticipated significantly favorable changes in Frontera's circumstances.

Upside scenario

We would raise our rating on Frontera's debt if power prices recover and its cash flow generation materially improves such that we do not believe the project is vulnerable to nonpayment.

Issue Ratings - Recovery Analysis

Key analytical factors

The recovery rating is '2', indicating our expectation of substantial (70%-90%; rounded estimate: 70%) recovery in a default scenario.

Simulated default assumptions

- Our simulated default scenario occurs in early 2021 due persistent weak demand and power prices that result in negative cash flows.
- We assume a going-concern enterprise value.
- We value the portfolio using a discounted cash flow approach and a 12% discount rate.

Simplified waterfall

- Simulated default year: 2021
- Discounted cash flow calculation at a rate of 12% from early 2021 through 2050: about $577 million
- Gross debt outstanding: about $787 million (including full revolver draw and six months of prepetition interest)
- --Recovery expectations: 50%-70% (rounded estimate: 70%; '2' recovery rating)

Related Criteria

- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Key Credit Factors For Power Project Financings, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Operations Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Issue-Level Ratings Lowered; Outlook Action; Recovery Ratings Revised

	To	From
Frontera Generation Holdings LLC		
Senior Secured	CCC/Negative	BB-/Stable
Recovery Rating	2(70%)	1(90%)

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