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Research Update:

Cyrela Brazil Realty S.A. 'BB' Ratings Affirmed; Outlook Remains Negative On Sovereign Rating Cap

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Overview

- We expect Brazil-based homebuilder Cyrela to continue gradually increasing cash flow generation over the next few quarters because of higher consumer confidence and better credit conditions.
- We also expect the company to maintain relatively stable leverage, distributing excess cash as dividends.
- We're affirming our long-term 'BB' global scale corporate credit rating and our 'brAA-' national scale corporate credit and debt ratings on the company.
- The negative outlook indicates that we would downgrade Cyrela if we were to lower Brazil's sovereign rating.

Rating Action

On Nov. 22, 2017, S&P Global Ratings affirmed its long-term 'BB' global scale corporate credit and 'brAA-' national scale corporate credit and issue-level ratings on Cyrela Brazil Realty S.A. Empreendimentos e Participacoes (Cyrela). The outlook remains negative, reflecting that of the sovereign.

Rationale

The ratings affirmation reflects our view that Cyrela will continue to report increasing cash flow generation over the next few quarters as the housing industry gradually recovers from weak demand due to Brazil's economic crisis. We expect improving consumer confidence and more active lending from banks to foster sales and reduce cancellations.

We expect Cyrela to report negative funds from operations (FFO) generation in 2017 due to non-recurrent provisions for the Grand Parc project and still high sales cancellations, but then expect FFO to improve from 2018 on, resulting in FFO to debt close to 20%. Because the percentage of completion for the accounting method for revenue recognition can lead to significant differences between the income statement (that impacts our FFO) and cash flow, we also incorporate in our financial risk profile the company's prudent approach to debt. We expect Cyrela to maintain low leverage over the next few years, measured by debt to capital between 20%-25%.

Although we remain optimistic about the company's cash flow prospects, the

Brazilian homebuilding industry has struggled during the past two years. We understand that Cyrela was able to withstand the crisis due to its good product diversification: it has a relevant presence in both the premium segment and in the more resilient government-housing program Minha Casa Minha Vida. Still, the company reported weaker operating cash flow than previously expected due to high cancellations in 2017. However, it compensated for that with lower dividends than previously expected, resulting in stable leverage. The monetization of Cyrela's current inventory position, its comfortable land bank, and reduced level of launches compared to pre-crisis levels give it a sufficient buffer to bear market sluggishness for another year or so.

In our base-case scenario, we assume:

- Brazil's GDP growth of 0.5% in 2017, 2.0% in 2018, and 2.2% in 2019;
- Brazil's inflation rate of 3.5% in 2017, 3.8% in 2018 and 4.1% in 2019;
- Basic interest rate (average) at 10.02% in 2017, 7.00% in 2018, and 7.25% in 2019;
- Launches of R$2.6 billion in potential sales value (PSV) in 2017, increasing to R$3.2 billion in 2018, and to R$3.6 billion in 2019. This reflects our expectation of demand recovery aligned with higher consumer confidence due to GDP growth as well as lower inflation and interest rates;
- Cancellations gradually decreasing--reaching about R$1.1 billion in 2018 and close to R$900 million in 2019--on adequate bank financing with lower interest rates;
- Net revenues of R$2.6 billion in 2017 and around R$3.1 billion in 2018 and 2019;
- Gross margin of 31%-33% over the next few years; with an improving trend due to both lower cancellations and need for discounts because of reduced inventories of finished units;
- Significant working capital generation in 2018, with a gradual increase in the speed of cash inflows from launches, receivables, and unsold inventory units as market conditions improve. Construction costs are also now lower than we saw in previous years because of the reduced level of launches, the higher stake of low income in total sales, and the lower levels of cash disbursement for land acquisition;
- Annual operating cash flow averaging R$800 million for 2017-2019;
- From 2018 on, we assume the company will distribute 95% of its free operating cash flow (FOCF) as dividends, as long as it maintains stable leverage and comfortable liquidity to cover its future obligations; and
- Gradual reduction of gross debt to around R$2.6 billion in 2019 due to current amortization of existing debt; partly compensated by new debt raised to finance new projects.

These assumptions result in the following credit metrics:

- FFO to debt negative in 2017, close to 20% in 2018 and around 25% in 2019, compared to 13.4% in 2016;
- Operating cash flow (OCF) to debt between 40% to 55% in 2017, 2018, and 2019; compared to 0.3% in 2016; and
- Debt to capital between 20%-25% in the next few years; compared to 26.7% in 2016.

The ratings on Cyrela remain capped at the same level as Brazil (BB/Negative/B). We stress the company under a hypothetical Brazilian sovereign default scenario, in which we believe the company wouldn't have sufficient sources of cash to cover its obligations. Because the homebuilding industry is highly correlated and sensitive to macroeconomic conditions, and because homebuilders depend on the banking sector that provides financing both for construction and homebuyers, we believe that during sovereign distress, the homebuilders' operations would face significant bottlenecks.

Liquidity

We assess Cyrela's liquidity as adequate because we expect its sources of cash to exceed uses by 1.2x for the next 12 months and sources to exceed uses even if EBITDA declines 30% from our forecast. Cyrela has sound bank relationships, and we expect the company to maintain an ample cushion for its financial covenants.

Principal liquidity sources:

- Cash position of R$1.5 billion as of Sept. 30, 2017;
- Forecasted FFO of about R$210 million in the next 12 months;
- Forecasted working capital inflows of around R$670 million in the next 12 months; and
- Contracted project loans of R$310 million.

Principal liquidity uses:

- Short-term debt of R$1.3 billion as of Sept. 30, 2017;
- Capital expenditures (capex) of R$30 million during the next 12 months;
- Land acquisition payments of R$123 million over the next 12 months; and
- Dividend payments of R$640 million during the next 12 months, assuming that the company presents sufficient cash generation.

Outlook

The negative outlook mirrors that on Brazil's sovereign rating, because we don't expect Cyrela to have sufficient liquidity sources to pay down its obligations in the scenario of a sovereign default.

Downside scenario

We would lower our global scale rating on Cyrela by one notch if we were to downgrade Brazil. We could also lower the ratings in the next 12 to 18 months if the company's cash flow generation start to decline again because of a new industry downturn that results in lower sales and higher cancellations. A downturn would pressure the company's profitability, resulting in FFO to debt consistently below 12% over several quarters and OCF to debt trending down to 15%.

Upside scenario

We could revise the outlook on Cyrela to stable from negative if we were to take the same action on Brazil, and if the company maintains an annual operating cash flow above R$500 million and stable leverage.

Ratings Score Snapshot

Corporate credit rating:
Global scale: BB/Negative/--
National scale: brAA-/Negative/--

Business risk: Fair
- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bb

Modifiers:
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Recovery Analysis

The issue-level rating on Cyrela's unsecured debt is 'brAA-' with a recovery rating of '3' that indicates our expectation of 55% recovery for unsecured lenders under a hypothetical default scenario of the company.

Key analytical factors

We assess Cyrela's recovery prospects using a simulated default scenario, assuming that Cyrela would be liquidated since its industry is asset-intensive. We assume the default occurs in 2022 because of a deteriorating Brazilian economy that leads to high cancellations, lower sales, difficulty selling inventory, and delays in receivables collection; reducing the company's cash flow generation.

Simulated default assumptions

- 25% shrinkage in inventory levels, with realization rates of 45% for raw land, 50% for land under development, 55% for construction in progress,

60% for completed homes, and 50% for investments in affiliates.
- 20% shrinkage and 50% realization rates for accounts receivable.

Simplified waterfall

- Net asset value after 5% administrative costs: R$3.15 billion
- Priority: R$2.16 billion (project debt and labor and tax obligations)
- Senior secured debt: R$547.5 million (CRIs)
- Senior unsecured debt: R$714 million (debentures, bank loans, and land acquisition payables)
- Recovery expectations of the existing unsecured debentures: 55%

*All debt amounts include six months of prepetition interest.

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Cyrela Brazil Realty S.A. Empreendimentos e Participacoes

Corporate Credit Rating	
Global Scale	BB/Negative/--
Brazil National Scale	brAA-/Negative/--
Senior Unsecured	brAA-
Recovery Rating	3(55%)

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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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