

### Research Update:

## Ratings On Espírito Santo Centrais Elétricas Affirmed, Outlook Stable

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## Overview

- Energy overcontracted costs hurt the Escelsa's operational margin last year; despite this, we expect Escelsa to maintain good cash generation and adequate liquidity.
- Standard & Poor's is affirming the 'BB+' global scale and 'brAA+' national scale ratings on Escelsa.
- The stable outlook reflects our expectation that the company will maintain its credit metrics and cash generation during the realization of its investment program and the distribution of its dividends.

## Rating Action

On April 30, 2012, Standard and Poor's Ratings Services affirmed its 'BB+' global scale and 'brAA+' national scale ratings on Espírito Santo Centrais Eletricas S.A. (Escelsa). The outlook is stable.

## Rationale

The ratings on Brazilian power distributor Escelsa reflect the stable regulatory framework in Brazil, greater GDP expansion in its concession area, in comparison with Brazilian average GDP, and better operational indicators relative to its peers. In contrast, risk factors include: the challenge to improve its credit metrics and cash generation after the third tariff cycle (scheduled for August 2013), some debt concentration, and some (over-contracted) energy excess that the company needs to sell in the short-term.

We expect that, despite last year's reduction in its operational margins, which reflected less-than-expected demand in that region (resulting in over-contracted energy), the company will nonetheless maintain good cash flow generation. We also believe that its credit metrics will remain quite strong. It will maintain these metrics by prudently managing its existing debt and capital investment needs. However, the company has limited headroom to improve its credit metrics--considering the lower remuneration on regulatory assets after the third tariff cycle and constant pressure from operational costs.

We see Escelsa's business risk profile as satisfactory, reflecting improvement in its operational indicators, with a decrease in energy losses and improvement in its service quality indicators, such as frequency and duration of power outages (DEC/FEC), which are in compliance with regulatory standards. Escelsa covers almost all of the municipalities in the state of Espírito

Santo, which has a population of 3.3 million inhabitants. In 2011, the demand was lower than expected, especially during the fourth quarter, led the company's energy offerings to be over-contracted. Industrial and residential demand were far less than the company expected. This, combined with increased energy costs, lead to a lower EBITDA margin. The company reported EBITDA of 14% during 2011, in comparison with 22.1% in 2010. We expect that the margins will return to historical levels of about 20%, considering that the company will adjust its energy purchases in line with expected energy demand for the next two years.

Although uncertainties about the tariff review cycle have diminished following the final ruling by the regulator, the impact on company's tariff will be visible from October 2013 on. Therefore, we projected decreased profitability of about 15% of EBITDA margin starts during 2014 and thereafter.

We view Escelsa's financial risk profile as significant. The reduction in its operational results deteriorated the company's credit metrics to FFO to adjusted debt of 41% and total adjusted debt to EBITDA of 3.8x during 2011, from 50% and 2.5x in the previous year. Our base case scenario assumes improvement in its credit metrics, reflecting better management of its energy purchases and operational costs, thereby resulting in a recovery in its credit metrics. We expect FFO to adjusted debt to remain at about 40%-45% and total adjusted debt to EBITDA of about 2.5x-3.0x. . We adjusted the company's total debt by including renegotiated taxes and pension fund liabilities

Escelsa is controlled by its holding company EDP Energias dos Brasil, which is majority-controlled by EDP Portugal (BB+/Negative/B). EDP's holding company controls others power assets in Brazil, including power generation and trading. It also controls Bandeirante Energia S. A. (brAA+).

### **Liquidity**

Escelsa's liquidity is adequate. As of December 2011, the company had cash available of Brazilian real (R\$) 105 million and free operating cash flow (FOCF) of R\$217 million, which it used mainly to distribute dividends and reduce debt. Its short term debt maturities amount to R\$146 million. We expect a strong FOCF of about R\$200 million during 2012 and 2013 and R\$130 million during 2014, when the third tariff review will take effect. Despite some concentration in its upcoming debt maturities during the next two years--of R\$ 289 million--the company has strong financial flexibility with good access to credit markets and long term funding for its investment needs, such as Banco Nacional de Desenvolvimento Economico e Social (BNDES--foreign currency: BBB/Stable; local currency: A-/Stable) and European Investment Bank (EIB-- (AAA/Negative/A-1+).

Our liquidity assessment includes the following expectations and assumptions:

- We expect liquidity sources (including cash, FFO, and committed lines available) to exceed the uses (capital expenditures and debt amortization) by about 1.50x and 1.73x during fiscal 2012 and 2013, respectively.

- Its cash uses will include capital expenditures of about R\$150 million per year for maintenance and the expansion of the network.
- We assume dividends distribution of 50%, with a bylaw minimum of 25% and 50% after the committed approval.
- Covenant headroom is sufficient to withstand EBITDA declines of 45%.

## Outlook

The stable outlook reflects our expectation that Escelsa will maintain its credit metrics by managing its contracted energy and operational costs and existing debt, while realizing capital investments and distributing dividends. We expect Escelsa to return to its historical levels of total debt to EBITDA of about 2.5x-3.0x and FFO to total debt of more than 40% during the next two years. We could raise the ratings if the company reports consistently adjusted total debt to EBITDA of less than 2.0x and FFO to debt of more than 50%. We could take a negative rating action if the company fails to maintain adequate cash generation and financial metrics, and if liquidity deteriorates, leading to FFO to adjusted total debt of less than 30% and total debt to EBITDA of more than 3.0x, or if there is further pressure to distribute dividends to its controlling company.

## Related Criteria And Research

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Methodology and Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011

## Ratings List

Ratings Affirmed

Espirito Santo Centrais Eletricas S.A.

Corporate credit rating

Global Scale BB+/Stable

National Scale brAA+/Stable

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