MOODY'S
INVESTORS SERVICE

# Credit Opinion: Energest S.A.

Global Credit Research - 11 Dec 2015

*Brazil*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Rating(s) Under Review |
| Issuer Rating -Dom Curr | *Baa3 |
| Senior Unsecured -Dom Curr | *Baa3 |
| NSR Senior Unsecured | *Aa1.br |
| NSR LT Issuer Rating | *Aa1.br |

* Placed under review for possible downgrade on December 10, 2015

## Contacts


| Analyst | Phone |
|---|---|
| Jose Soares/Sao Paulo | 55.11.3043.7300 |
| Paco Debonnaire/Sao Paulo | |
| William L. Hess/New York City | 1.212.553.1653 |


## Key Indicators

[1]**Energest S.A.**

| | 12/31/2013 | 12/31/2012 | 12/31/2011 | 12/31/2010 | 12/31/2009 |
|---|---|---|---|---|---|
| (CFO Pre-W/C + Interest) / Interest | 9.2x | 9.2x | 9.0x | 9.7x | 18.1x |
| (CFO Pre-W/C) / Net Debt | 95.1% | 74.0% | 237.6% | 58.4% | 41.7% |
| RCF / Net Debt | 55.2% | -4.1% | 198.1% | 47.8% | 18.8% |
| (CFO Pre-W/C) / Debt | 68.9% | 60.1% | 84.5% | 39.7% | 37.0% |
| RCF / Debt | 40.0% | -3.3% | 70.4% | 32.4% | 16.7% |

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

*Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.*

## Opinion

### Rating Drivers

- Risk associated with potential energy rationing and exposure to the spot market

- Relatively stable and predictable cash flow supported by medium-term supply contracts

- High concentration in one single client (EDB's affiliate EDP Comercializadora)

- High dividend pay-out ratio expected over the next three years

## Corporate Profile

Energest S.A (Energest), a wholly-owned subsidiary of EDP - Energias do Brasil (EDB), is both a holding and operating company with interests in the generation of electricity. Energest has 395.6MW of installed capacity (252.6 Average MW of physical energy) consisting of 12 hydro power plants, of which two are medium sized hydroelectric power plants (above 30MW of capacity) and ten are small power plants (between 1MW and 30MW of installed capacity). These hydro plants are located in the southeastern state of Espírito Santo and the Midwestern state Mato Grosso do Sul. In 2014, Energest posted consolidated net sales of BRL 479 million (USD 203 million), EBITDA of BR L177 million (USD 75 million) and net profit of BRL 113 million (USD 48 million).

## Recent Events

On December 10, 2015, Moody's placed Energest` s ratings under review for downgrade following the placement of Brazil's issuer and bond ratings under review for downgrade on December 09, 2016.

On March 6, 2014, Moody's América Latina Ltda affirmed the Baa3/Aa1.br issuer ratings on Energest. Moody's also affirmed the Baa3/Aa1.br ratings on BRL 120 million in debentures issued by Energest that are scheduled to mature on April 24, 2017. The outlook for all ratings was changed to negative from stable.

On March 21, 2012, Moody's assigned a Baa3 local currency issuer rating on the global scale and Aa1.br issuer rating on the Brazilian national scale to Energest. At the same time, Moody's assigned a Baa3 rating on the global scale and Aa1.br rating on the Brazilian national scale to senior unsecured amortizing 5-year BRL 120 million debentures issued by Energest in the local market. The outlook was stable for all ratings. This was the first time Moody's had assigned a rating to Energest.

## SUMMARY RATING RATIONALE

The Baa3 and Aa1.br ratings reflect the strong credit metrics for the rating category and the relatively stable and predictable cash flow that is supported by medium-term energy supply contracts in both the regulated and free markets. The company's proven expertise at operating small hydro plants, along with the adequate level of competitiveness of its assets, further supports the ratings. The relatively sizeable capital expenditures and the higher level of dividend payments expected over the near term constrains the ratings as does the relatively short life of the Brazilian regulatory framework in its current form. The potential volatility of cash flow from a severe dry season and the increasing volume of free market sales concentrated in one single client, consisting of its affiliate EDP Comercializadora, further constrains the ratings.

## Structural Considerations

In spite of also being a holding company, Energest's issuer rating is at the same level of the implicit operating subsidiaries' issuer ratings to reflect that there is no structural subordination of any debt at the holding company level to that of the operating companies. This stems from the fact that the bulk of consolidated cash flow is expected to be generated by the holding company, which Moody's estimates will average 64% of consolidated cash flow within the next three years considering that the company's current corporate structure will not materially change during this period either from divestitures or acquisitions. Lenders to operating subsidiaries generally have claims on cash flow that are superior to those of the holding company creditors which can also restrict the financial flexibility of the holding company.

## DETAILED RATING CONSIDERATIONS

HYDROLOGICAL RISK SOMEWHAT MITIGATED BY MRE (ENERGY RELOCATION MECHANISM)

The MRE is a mechanism aimed at achieving full utilization of national production capacity that involves energy transfers between generators. The hydrological risk is shared among all hydropower producers through the MRE, a mechanism based on the transfer of surplus energy generators to those with a shortage, thus optimizing energy supply of the National Interconnected System.

The MRE operates as a hedge by distributing produced energy between generators so that any surplus or deficit relative to physical assured energy of hydroelectric plants may be equally distributed. As a result, a plant which generates less than its physical guarantee, either due to lack of water or the decision of the ONS (National System Operator), benefits from this mechanism by receiving the energy shortfall from the other generators to cover its deficit.

In case the energy produced under the Energy Relocation Mechanism is not sufficient to cover all the contracts, ONS will dispatch the more expensive thermal energy by the order of merit, wherein the costs will be distributed to all hydropower producers in proportion to their assured energy. Based on this mechanism, the hydropower producers absorb the additional costs from the dispatch of more expensive thermal power.

In light of the current severe drought mainly in the southeastern and northeastern regions of the country, ONS has been dispatching the more expensive thermal power and reducing the production of hydro power to preserve water at the Brazilian hydro-water reservoirs and avoid an energy rationing. As a result, the generation scaling factor (GSF), an indicator of the level of exposure to the spot market averaged 0.90 in 2014, which forced hydro power companies to acquire around 10% of their physical energy in the spot market at high average spot prices of BRL 650 per megawatt hour. Year-to-date the GSF has been at the BRL 388.48 per megawatt hour ceiling price. We have estimated that the GSF will average 0.85 in 2015 leading hydro generators to incur further losses, which will be partly tempered by the lower ceiling spot price of BRL 388.48 per megawatt hour as mandated by the regulator at the end of 2014.

MAIN CASH FLOW OUTLAYS FROM HIGHER CAPITAL EXPENDITURES AND PAYMENT OF DIVIDENDS

Annual capital expenditures could reach as much as BRL 30 in 2015 and decrease thereafter to around BRL 25 million because of increased costs tied to the maintenance of aging power plants. Energest completed the expansion of installed capacity by 18 MW of two existing small power plants by the middle of 2013.

Management expects capital expenditures to decrease thereafter but we have conservatively assumed that capital expenditures will remain at the BRL 25 million level as a result of new projects coming on stream, which is in line with the company's current business strategy.

We have also assumed a high 100% dividend pay-out ratio throughout the projected period. While this may appear to be a relatively conservative assumption, we believe that this ratio is likely assuming that the company is able to meet certain existing financial covenants embedded in some of its lending contracts and that it is able to maintain adequate access to long-term funding to meet its main cash outlays as envisaged in our projections.

We believe that Energest will distribute the maximum amount of dividends possible but within the legal limits determined by CVM or allowed by ANEEL without jeopardizing its current strong capital structure. The risk of breaching the current Gross Debt/EBITDA financial covenant of 3.5 x embedded in the company's indenture is very low over the medium term in our view. In 2014, this ratio was 1.1x as calculated by the parameters determined in the debentures at the level of the holding company which provides the company with substantial room to potentially increase its leverage.

CASH FLOW SUPPORTED BY MEDIUM-TERM SUPPLY CONTRACTS WITH INCREASED PARTICIPATION OF FREE CONSUMERS

Energest has gradually moved from the safer regulated market, consisting of long-term energy supply contracts to the regulated distribution companies, to the unregulated market largely composed of large industrial free consumers with tenors typically around five years.

EDP Comercializadora is expected to represent around 40% of total volume sales. EDP Comercializadora, also a wholly-owned subsidiary of EDB (EDB; Ba1; under review for downgrade) stands out as a major credit risk given the expected deterioration in the overall creditworthiness of EDB and its other operating subsidiaries.

EDP Comercializadora is a pure electricity trading company and plays a strategic role within the EDB group. Most of the large industrial consumers that migrated from the regulated market of Bandeirante and Escelsa to the free market over the past several years have signed bilateral supply contracts with EDP Comercializadora.

Under normal circumstances, we expect that Energest will post strong cash flows as measured by CFO (cash from operations) over the next three years as a result of relatively stable operating margins, which are underpinned by medium- term electricity supply contracts in both the regulated and free markets. Accordingly, we estimate that the CFO - WC over debt ratio could exceed 80% while interest coverage will average 12.0x in the same period.

The major downside risks of this projection are higher exposure to the spot market than what we are forecasting of around 15% in 2015 and 8% in 2016 and that the company's current hedging strategy is not as efficient as it was in 2014 to offset the company's exposure to the spot market.

We do not rule out that in light of an expected material reduction in the company's debt over the next three years, Energest will distribute much higher dividends than what we are projecting or execute capital splits, which could be accomplished through increased leverage by raising new debt in the local capital and banking markets, as management has indicated it will do. Under this scenario, Energest's credit metrics will deteriorate but the magnitude of such a deterioration will depend on the level of dividends along with potential capital splits, which would ultimately depend on the cash needs of its parent company EDB.

### Corporate Governance

As part of the EDB group, the company's corporate governance practices are largely dictated by its parent. The quality of information contained in its audited quarterly and annual financial statements are adequate as is the level of disclosure provided by management. EDB has corporate governance practices that are above the average of Latin American issuers. EDB is a publicly listed company with shares traded on the Novo Mercado of Bovespa.

EDB's Board of Directors is made up of eight members, of which three are considered independent. The board relies on four support committees: Audit, Sustainability, Corporate Governance and Related Parties, and Compensation. The Audit, the Sustainability and the Corporate Governance and Related Parties Committees are permanent in nature and are comprised of three members where at least one is independent. There is also a Fiscal Council composed of three members and three alternates elected for a maximum term of one year; however, it is non-permanent and convened only when requested by shareholders.

### Liquidity

Like most Brazilian companies, Energest does not have committed banking facilities to meet any unexpected cash disbursement needs. Despite this limitation, we deem Energest's liquidity position as adequate given EDB's proven resilient access to the local banking and capital markets. In addition, Energest held a healthy consolidated cash position of BRL 55.8 million, which comfortably covers short-term debt of BRL 21.1 million as of December 31, 2014.

We conservatively estimate that Energest will post positive free cash flow over the next two years in spite of expected high distribution of dividends because of its healthy CFO and lower capital expenditures going forward. The major downside risk for this forecast is the company's execution of a capital split or the distribution of higher dividends.

### Rating Outlook

The review for downgrade follows the placement of Brazil's Baa3 issuer and bond ratings under review for downgrade on December 9, 2015. The company's operational and financial performance is subject to the evolution of the macroeconomic and regulatory environment in Brazil as captured by the sovereign rating.

### What Could Change the Rating - Up

In light of this rating action, an upgrade is very unlikely over the medium term.

### What Could Change the Rating - Down

A downgrade of Brazil's sovereign rating would exert downward pressure on the assigned ratings. The ratings could also be downgraded if there is an unexpected deterioration of credit metrics so that the CFO Pre-W/C over debt ratio falls below 20% and interest coverage stays below 3.5x for an extended period. There could be growing pressure for a rating downgrade if EDB's rating is downgraded as well.

## Rating Factors

**Energest S.A.**

| **Unregulated Utilities and Unregulated Power Companies Industry Grid** [1][2] | **Current FY 12/31/2013** | | | [3]**Moody's 12-18 Month Forward ViewAs of 3/3/2015** | |
|---|---|---|---|---|---|
| **Factor 1 : Scale (10%)** | **Measure** | **Score** | | **Measure** | **Score** |
| a) Scale (USD Billion) | Caa | Caa | | Caa | Caa |
| **Factor 2 : Business Profile (40%)** | | | | | |
| a) Market Diversification | Ba | Ba | | Ba | Ba |
| b) Hedging and Integration Impact on Cash | Baa | Baa | | Baa | Baa |

| | | | | |
|---|---|---|---|---|
| Flow Predictability | | | | |
| c) Market Framework & Positioning | Ba | Ba | Ba | Ba |
| d) Capital Requirements and Operational Performance | Baa | Baa | Baa | Baa |
| e) Business Mix Impact on Cash Flow Predictability | | NA | | |
| **Factor 3 : Financial Policy (10%)** | | | | |
| a) Financial Policy | Baa | Baa | Baa | Baa |
| **Factor 4 : Leverage and Coverage (40%)** | | | | |
| a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg) | 9.1x | A | 15.9x | Aa |
| b) (CFO Pre-W/C) / Net Debt (3 Year Avg) | | NA | | |
| c) RCF / Net Debt (3 Year Avg) | | NA | | |
| b) (CFO Pre-W/C) / Debt (3 Year Avg) | 69.8% | Aa | 102.7% | Aaa |
| c) RCF / Debt (3 Year Avg) | 31.8% | A | 63.5% | Aaa |
| **Rating:** | | | | |
| a) Indicated Rating from Grid | | Baa2 | | Baa1 |
| b) Actual Rating Assigned | | | | Baa3 |

| Government-Related Issuer | Factor |
|---|---|
| a) Baseline Credit Assessment | |
| b) Government Local Currency Rating | |
| c) Default Dependence | |
| d) Support | |
| e) Final Rating Outcome | |

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2013; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.