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Credit Opinion: Energest S.A.

Global Credit Research - 28 Mar 2013

Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
Senior Unsecured -Dom Curr	Baa3
NSR Senior Unsecured -Dom Curr	Aa1.br
NSR LT Issuer Rating -Dom Curr	Aa1.br

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Key Indicators

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

ACTUALS	**2012**	**2011**	**2010**	**2009**
(CFO Pre-W/C + Interest) / Interest Expense	**8.9x**	**8.8x**	**6.4x**	**6.8x**
(CFO Pre-W/C) / Debt	**59.4%**	**61.6%**	**39.4%**	**34.8%**
(CFO Pre-W/C - Dividends) / Debt	**-4.2%**	**51.3%**	**32.1%**	**14.5%**
FCF / Debt	**-32.7%**	**21.9%**	**12.1%**	**-23.7%**

[1] All ratios calculated in accordance with the Global Unregulated Utilities and Power Companies Methodology using Moody's standard adjustments.

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

Opinion

Rating Drivers

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

- Proven expertise on operating small hydro power plants

- Implicit support from the parent company EDB

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

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

Corporate Profile

ENERGEST S.A (ENERGEST), a wholly controlled subsidiary of EDP Energias do Brasil (EDB), is both a holding

and operating company with interests in the generation of electricity.

ENERGEST has 397.3MW of installed capacity (253.4 Average MW of assured energy) consisting of 15 hydro power plants, of which two are medium sized hydroelectric power plants (above 30MW of capacity), ten are small power plants (between 1MW and 30MW of installed capacity) and three hydro power plants with less than 1 MW of installed capacity.

These hydro plants are located in the southeastern state of Espirito Santo and the Midwestern state Mato Grosso do Sul. In 2012, ENERGEST posted net sales of BRL 283 million (USD145.1.million), EBITDA of BRL164 million (USD 84.1 million) and net profit of BRL104 million (USD53.3 million).

Recent Events

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 S.A (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 support 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 ENERTRADE, 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. 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

STABLE CASH FLOW SUPPORTED BY MEDIUM-TERM SUPPLY CONTRACTS

We expect ENERGEST to 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 will average 42.0% while interest coverage will average 5.7x in the same period.

Nevertheless, free cash flow is estimated to be negative over the next two years due to relatively sizeable capital expenditures and the high level of dividends expected to be distributed resulting in average annual negative free cash flow of around BRL6 million or 2% over debt.

Our projections are conservative in that we project lower operating margins mainly from 2013 through 2014 to reflect potential increased costs with the acquisition of more expensive thermo electricity to meet its contractual obligations given weaker hydrology conditions. Our view is that the Brazilian system operator (ONS) is likely to dispatch the more expensive thermo electricity during this period to save water at the Brazilian reservoirs based on the operational dispatch procedural concept of order of merit in which case all generation companies share the hydrological risk in proportion to their assured energy.

In addition, the recent decision of CNPE (Brazilian Council of Energy Policy), to include in the calculation of PLD

(spot market price) the costs associated with the dispatch of thermo energy out of the order of merit, could pose additional costs to generation companies, not just those exposed to spot market prices but also virtually all hydro generation companies, which in accordance with this new methodology would also assume part of these costs which otherwise would be paid by the final consumers.

The major downside risks in our projections are a dry season that is unexpectedly severe across the country but in particular in the states of Espirito Santo and Mato Grosso do Sul, replacement of energy supply contracts at lower tariffs, and higher than expected capital expenditures and distribution of dividends resulting in higher leverage and barely adequate funding with potential pressure on liquidity.

HYDROLOGICAL RISK 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 guaranteed energy of hydroelectric plants may be equally distributed. As a result, a plant which generated 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 case ONS dispatches thermal power out of the order of merit, the associated costs stemming from this decision will be assumed by final energy consumers.

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

Annual capital expenditures could reach as much as BRL 50 million through 2013 because of increased costs tied to the maintenance of aging power plants and the expansion of installed capacity by 18MW of two existing small power plants. According to management, these two expanded plants are expected to start operating in the second quarter of 2013.

Management expects capital expenditures to decrease thereafter but we have conservatively assumed that capital expenditures will remain at the BRL 30 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 97% dividend pay-out ratio throughout the projected period. While this may appear to be a relatively conservative assumption, we believe that such a ratio is likely assuming the company is able to meet certain existing financial covenants embedded in some of its lending contracts and that it maintains adequate access to long-term funding to meet its main cash outlays as envisaged in our projections.

We believe that ENERGEST will distribute dividends as much as 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 debentures indenture is very low over the medium term in our view. In 2012, this ratio was 2.0x as calculated by the parameters determined in the debentures, at the level of the holding company, which provides the company with much room to potentially increase its leverage.

INCREASED PARTICIPATION OF FREE CONSUMERS

Going forward, ENEGEST will gradually move 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.

ENERTRADE is expected to represent around 40% of total volume sales. ENERTRADE, also a wholly-owned subsidiary of EDP Energias do Brasil (EDB; Ba1; stable) would stand out as a potential major credit risk if it were not for this affiliate's track record and the overall creditworthiness of EDB and its other operating subsidiaries.

ENERTRADE 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 ENERTRADE. Both Bandeirante and Escelsa, are electricity distribution companies controlled by EDB and have issuer ratings of Baa3 with stable outlooks.

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 four are considered independent (two appointed by minority shareholders). The board relies on three support committees: Audit, Sustainability and Corporate Governance, and Compensation.

The Audit and the Sustainability 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 44.2 million, which comfortably covers short-term debt of BRL 21 million as of December 31, 2012.

We conservatively estimate that ENERGEST will post break-even to negative free cash flow over the next two years because of higher expected capital expenditures and distribution of dividends; however, projected CFO along with the borrowing of long-term debt are expected to maintain liquidity at the current adequate level.

New capital expenditures to further expand the company's installed capacity would most likely rely on some long-term funding from BNDES, which has in many occasions indicated its willingness to fund up to 60% of Brazilian infrastructure projects.

Rating Outlook

The stable outlook reflects our expectation that ENERGEST will continue to post stable cash flows and manage its capital expenditures and the distribution of dividends in tandem with its cash flow capacity so that the company's credit metrics remain adequate for the rating category.

What Could Change the Rating - Up

A rating upgrade is unlikely to occur in the near term; however, the ratings could be upgraded if ENERGEST posts stronger credit metrics so that CFO Pre-W/C over debt is greater than 40% and interest coverage becomes higher than 6.0x on a sustainable basis. A rating upgrade would also require, most likely, an upgrade of EDB as well.

What Could Change the Rating - Down

The ratings or outlook could 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.

Global Unregulated Utilities and Power Companies published in August 2009	Current 12/31/2012		Moody's 12 - 18 month Forward View	
Factor 1: Market Assessment, Scale and Competitive Position (20%)	**Measure**	**Score**	[1]**Measure**	**Score**
a) Market and Competitive Position (15%)		Baa		Baa
b) Geographic Diversity (5%)		Ba		Ba
Factor 2: Ability to Recover Costs and Earn Returns (25%)				
a) Effectiveness of hedging strategy (10%)		Baa		Baa
b) Fuel Strategy and mix (5%)		Ba		Ba
c) Capital requirements and operating performance (5%)		Ba		Ba
Factor 3: Financial policy (10%)		Baa		Baa
Factor 4: Financial Strength - Key Financial Metrics (50%) [2]				
a) CFO pre-WC + Interest / Interest (15%) (3yr Avg)	7.9x	A	5.6x - 6.4x	Baa
b) CFO pre-WC / Debt (20%) (3yr Avg)	52.4%	A	39.9% - 41.2%	A
c) RCF / Debt (7.5%) (3yr Avg)	26.7%	A	9.7% - 10.1%	Ba
d) FCF / Debt (7.5%) (3yr Avg)	1.2%	Ba	(-1.2%) - (-3.8%)	B
Rating:				
a) Methodology Implied Issuer Rating		Baa2		Baa3
b) Actual Issuer Rating				Baa3

[1] 12 - 18 month Moody's forecast [2] 3-year historical average

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