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Research Update:

Espírito Santo Centrais Elétricas S.A. 'BB+' Global Scale And 'brAA+' National Scale Ratings Affirmed, Outlook Stable

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Overview

- Despite Escelsa's lower profitability due to exceptional events in the Brazilian electric sector, the company is expected to maintain efficient operating metrics and generate higher EBITDA in the next few years.
- We are affirming our 'BB+' global scale and 'brAA+' national scale ratings on Escelsa.
- The stable outlook reflects our expectation that Escelsa will improve its debt to EBITDA to less than 3.0x and funds from operations to debt to more than 30% in the next two years.

Rating Action

On June 5, 2013, Standard & Poor's Ratings Services affirmed its 'BB+' global scale and 'brAA+' national scale ratings on Espirito Santo Centrais Eletricas S.A. (Escelsa). The outlook is stable.

Rationale

The ratings on Escelsa reflect our assessment of the company's business risk profile as "satisfactory," its financial risk profile as "intermediate," and its liquidity as "adequate." We view the company's credit quality as integrally linked with that of its parent company, EDP Energias do Brasil S.A. (EDP; not rated), which is in turn linked to its controlling shareholder, EDP - Energias de Portugal S.A. (BB+/Stable/B). The linkage between Escelsa and EDP is based on our view that EDP manages its subsidiaries under an integrated financial strategy and it is actively engaged in managing each of their operations.

Despite more aggressive credit metrics in 2012 and the first quarter of 2013, we expect debt to EBITDA to remain less than 3.0x and funds from operations (FFO) to debt of more than 30% in the next two years. The company has consistently applied a moderate financial policy by financing about 35% of its capital expenditures via Banco Nacional de Desenvolvimento Economico e Social's (BNDES; foreign currency: BBB/Stable/--; local currency: A-/Stable/--) loans at very attractive rates and by maintaining debt levels at about R$700 million (not adjusted) in the past few years. In our view, this policy, together with a moderate growth in cash flows with FFO of more than

R$300 million and free operating cash flow (FOCF) of more than R$150 million in the next two years, reflects Escelsa's "intermediate" financial risk profile.

In the last quarter of 2012 and the first quarter of 2013, all electricity distribution companies in Brazil faced higher energy costs because of a higher electricity dispatch by thermal power, due to a drought. Energy costs, as stated in the Brazilian regulation, are passed through to end-users through the tariff adjustment mechanisms. Nevertheless, Escelsa would only be able to pass through such costs following its August 2013 tariff review. This time mismatch, coupled with the sharply higher energy costs, reduced EBITDA in 2012 and the first quarter of 2013. We expect Escelsa's EBITDA to return to historical levels thanks to the recent government decree that allows the use of a sector reserve account (Conta de Desenvolvimento de Energia [CDE]) to return part of the extraordinary costs to distributors on a monthly basis and the upcoming tariff review, which should increase tariffs by 1%-2%, according to our base case. As of May 2013, Escelsa has received R$95 million from the CDE account, which should offset energy costs and boost EBITDA. As such, we view the recently reported credit metrics as extraordinary and we expect them to improve to the aforementioned levels by year-end.

We view Escelsa's business risk profile as "satisfactory" based on its sound competitive position due to a rising energy demand concession area, an improving regulatory framework, and efficient operating metrics. About 60% of Escelsa's energy demand comes from residential and commercial clients, which make EBITDA more stable and predictable. Additionally, we view that the regulatory framework has shown positive signs following the introduction of decree 7.945, which allowed for a more timely compensation of extraordinary cost increases. Also, the company's healthy operating metrics, with DEC (duration of interruption) and FEC (frequency of interruption) indicators compliant with regulatory standards and energy losses at 13.5%, support the rating. Somewhat mitigating these strengths are some uncertainties regarding the third tariff review. Nevertheless, our base case assumes a 1%-2% rise in tariffs, which should lead to EBITDA levels of R$360 million - R$380 million in 2013.

Escelsa's concession area is composed of 70 of the 78 municipalities of the state of Espirito Santo, with about 1,286 clients and 3.3 million people.

Liquidity

We assess Escelsa's liquidity as "adequate" based on the following expectations and assumptions:

- Liquidity sources (including cash, FFO, and committed lines available) to exceed the uses (capital expenditures and debt amortization) by more than 1.3x in the next two years;
- Its cash uses will include annual capital expenditures of about R$150 million for maintenance and the expansion of the network;
- Dividends payout of 25% in 2013 and 90% afterwards;
- BNDES to finance 35% of the company's total capital expenditure; and

- Covenant headroom is sufficient to withstand EBITDA declines of at least 20%.

As of March 2013, the company had cash available of R$178 million and FOCF of R$150 million, which will be used mainly to distribute dividends and reduce debt. Its short-term debt maturities total R$153 million. We expect a FOCF to remain above R$150 million during 2013 and 2014. Escelsa's adequate financial flexibility, with good access to credit markets and long-term funding for its investment needs mainly from BNDES and local capital markets, partially offsets its aggressive dividend policy, high capital expenditure needs of around R$150 million per year, and somewhat high debt maturities in the next two years of R$418 million.

Outlook

The stable outlook reflects our expectation that Escelsa will improve its credit metrics to historical levels of debt to EBITDA below 3.0x and FFO to debt above 30% by the end of 2013 and afterwards and will continue showing sound operating metrics, with DEC and FEC levels below the minimum required by ANEEL. This expectation is mainly based on an improvement in EBITDA for 2013 and 2014 to R$360 million – R$380 million due to additional funds coming from the CDE account and a positive tariff review of 1%-2% in August 2013, as well as a dividend policy that doesn't compromise the "adequate" liquidity. We could raise the ratings if we perceive that the credit quality of its controlling shareholders, EDP and EDP Energias de Portugal S.A., improves. We could take a negative rating action if the company fails to maintain adequate cash generation and credit metrics in line with our expectation due to a negative impact of the third tariff review, an overly aggressive dividend policy that compromises its liquidity or an increase in leverage that deteriorates debt to EBITDA to above 3.5x and FFO to debt to less than 30% consistently over time.

Related Criteria And Research

- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings List

Ratings Affirmed

Espirito Santo Centrais Eletricas S.A.	
Corporate Credit Rating	BB+/Stable/--
Brazil National Scale	brAA+/Stable/--

Bandeirante Energia S.A.	
Corporate Credit Rating	
Brazil National Scale	brAA+/Stable/--

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