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CREDIT OPINION

3 April 2019

Update

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RATINGS

EDP Sao Paulo Distribuicao de Energia S.A.

Domicile	Brazil
Long Term Rating	Ba2
Type	LT Corporate Family Ratings
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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EDP Sao Paulo Distribuicao de Energia S.A.

Update to credit analysis

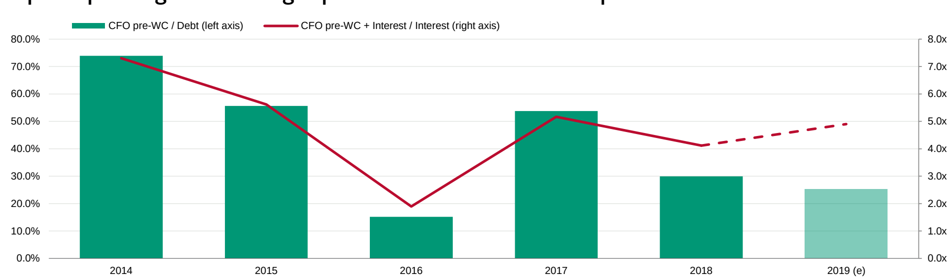
Summary

The credit profile of EDP- Sao Paulo Distribuição de Energia S.A. (EDP - Sao Paulo, Ba2/Aa1.br stable) reflects (1) the relatively stable and predictable nature of its cash flow derived from a distribution concession that is valid through October 2028, (2) the company's strong credit metrics for the rating category, illustrated by the ratio of cash flow from operations before changes in working capital (CFO pre-WC) to debt of 30% and interest coverage ratio of 4.1x in 2018, and (3) an evolving regulatory environment with a track record of support aimed at providing timely relief to electricity distribution companies facing financial risk. Continued access to the local capital markets and the implicit support from its parent holding company EDP - Energias do Brasil S.A. (EDB; corporate family rating Ba2/Aa2.br stable) are also important rating considerations.

Constraining EDP - Sao Paulo's ratings are (1) the company's increasing leverage to support capital investments to upgrade the network and prevent losses before the next tariff review cycle in October 2019, (2) the expectation of high dividend distributions to the parent, and (3) the exposure to high working capital needs according to hydrological conditions. The ratings remains somewhat constrained by the Government of Brazil's rating (Ba2 stable), given the intrinsic links between the company and the credit quality of the sovereign because of its regional customer base.

Exhibit 1

Capital spending and working capital needs will constrain improvement in credit metrics in 2019



Source: Moody's Investors Service

Credit strengths

» Economic recovery supporting cash flow generation over the next 12-18 months

» Strong credit metrics for the rating category, despite leverage increase

» Evolving regulatory framework with a track record of consistent decisions and timely support to the utility

Credit challenges

» Exposure to volatile working capital needs amid unfavorable hydrological conditions

» Expectation of high dividend payout to the parent, EDB

» Investment requirements on grid expansion and upgrades expected to remain high beyond the current review cycle

Rating outlook

The stable outlook on EDP - Sao Paulo reflects our expectation that the company's credit metrics will remain well positioned for the rating category, although relatively lower than the historical levels. The stable outlook on EDP - Sao Paulo is also in line with that on Brazil's sovereign rating.

Factors that could lead to an upgrade

The company's ratings are currently constrained by Brazil's sovereign rating; therefore, a rating upgrade would be considered if the sovereign rating is upgraded. A rating upgrade or a change in outlook to positive would also depend on a sustained improvement in the relevant credit metrics and its liquidity profile, or a material improvement in the regulatory frameworks under which EDP - Sao Paulo operates. Quantitatively, the ratings could be upgraded if we see a continued improvement in the company's credit metrics, so that:

» the ratio of CFO pre-WC to total debt approaches 55%, and

» interest coverage remains closer to 5.5x on a sustained basis.

Factors that could lead to a downgrade

Downward rating pressure could arise if there is a deterioration in EDP - Sao Paulo's liquidity position, resulting from weaker-than-expected growth in its concession area, or if there is any change in the perceived level of support from the electricity regulatory framework. A downgrade of Brazil's sovereign rating could also exert downward pressure on EDP - Sao Paulo's rating. Quantitatively, the ratings could be downgraded if we see a sustainable deterioration in its credit metrics, so that:

» the ratio of CFO pre-WC to debt falls below 25%, or

» interest coverage remains sustainably below 4.0x.

Key indicators

Exhibit 2
EDP - Sao Paulo Distribuição de Energia S.A.

	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
CFO pre-WC + Interest / Interest	7.3x	5.6x	1.9x	5.2x	4.1x
CFO pre-WC / Debt	73.9%	55.6%	15.2%	53.8%	29.9%
CFO pre-WC – Dividends / Debt	48.3%	38.8%	-12.9%	48.8%	26.1%
Debt / Capitalization	44.8%	47.0%	46.0%	50.5%	54.8%

[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™

Profile

EDP - Sao Paulo Distribuição de Energia S.A. (EDP - Sao Paulo), headquartered in São Paulo, Brazil, is an electricity distribution utility fully controlled by EDB, a diversified utility group that is in turn controlled by EDP - Energias de Portugal, S.A. (Baa3 stable). EDP - Sao Paulo serves around 1.8 million clients in 28 municipalities between Alto Tietê in the Paraíba valley and the north coast of the State of Sao Paulo (Ba2 stable), a highly industrialized area. In 2018, EDP - Sao Paulo reported net revenue of BRL3.8 billion (not including construction revenue of BRL319 million, as per Moody's adjustments) and net income of BRL213 million, with 15,192 gigawatt hours of distributed energy volumes, representing around 3.2% of the electricity consumed in Brazil's integrated system.

Detailed credit considerations

Track record of resilient credit metrics despite economic volatility

EDP - Sao Paulo exhibits a healthy credit metric profile, supported by its regulated business in an industrialized and well-developed service region, along with its experienced management team.

In 2018, total energy distribution reached 15,192 gigawatt hours, a 2.6% growth from 2017, driven mostly by higher electricity demand from consumers in the free market. The demand from regulated customers remained relatively unchanged compared with that in 2017, reflecting the country's slow pace of economic recovery. Despite the still-weak volumes on its captive consumer base, EDP - Sao Paulo maintained control over its energy balance in 2018, keeping the exposure to over-contracted energy volumes at around 105.7%, which is close to the regulatory threshold of up to 105% for cost recovery allowances.

In 2018, EDP - Sao Paulo experienced moderate increases in non-manageable costs of around 4%, driven by higher sector charges and the devaluation of local currency with an impact on dollar-denominated power purchase agreements with Itaipu Binacional. Recurring manageable costs, including general and administrative expenses and third-party services, also increased by about 4% from 2017. The negative impact of higher operating costs was partially compensated by a 16.2% tariff increase granted by the regulator in October 2018 as part of the company's annual tariff review process, resulting in a relatively stable operating margin for EDP - Sao Paulo.

As a result, EDP - Sao Paulo's ratio of CFO pre-WC to debt dropped to 30% from 54% in 2017, while the interest coverage ratio fell to 4.1x in 2018 from 5.2x. Although relatively weaker, these metrics remain well positioned for the Ba2 rating category.

We view regulated electric utilities as well positioned to benefit from the gradual industrial production recovery and progressive decline in unemployment in the country. We forecast that regulated electricity consumption in Brazil will resume growth to around 2% in the next 12-18 months, in line with the GDP growth. In this scenario, we expect EDP - Sao Paulo's ratio of CFO pre-WC to debt to remain in the 25%-30% range, while its interest coverage would remain around 4.5x-4.9x. An improvement in leverage is currently constrained by Moody's expectation that the company's capital spending will remain high along with large dividend distributions to the parent.

Regulatory environment evolving positively

The National Agency of Electric Power (ANEEL) has consistently applied tariff increases in line with its methodology, and has demonstrated that it is closely monitoring the performance and working capital needs of distribution companies. Recent regulatory decisions aimed at mitigating the impact of high energy costs and the economic recession tend to indicate a more supportive regulatory framework for Brazilian distribution companies. For example, in February 2017, ANEEL revised its methodology related to periodic tariff adjustments and to the tariff flag mechanism to allow distribution companies to raise tariffs sooner based on a projection of their future energy costs. We expect the sector's benign regulatory framework to continue over the next 12-18 months.

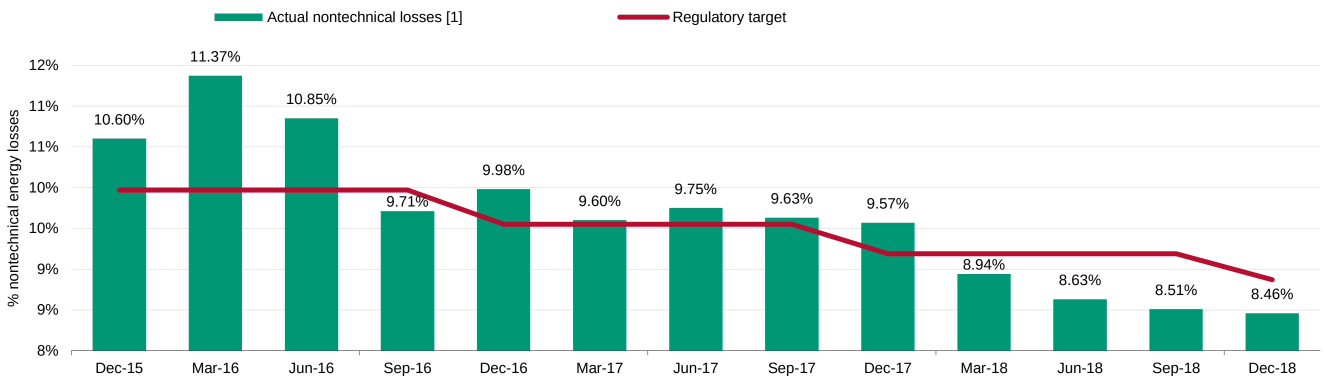
During the most recent economic recession, EDP - Sao Paulo received timely regulatory tariff adjustments that helped mitigate the impact of high energy costs. In February 2015, ANEEL approved an extraordinary tariff adjustment of 32.18% for EDP - Sao Paulo, which helped reduce the negative effects of higher energy costs because of the severe drought season. In October 2015, the regulator also completed the fourth periodic tariff review cycle for EDP - Sao Paulo, which brought an increase of about 19% to its regulatory EBITDA, as per the authorization to earn a return on a net regulatory asset base of BRL1.7 billion. For the next review cycle scheduled in October 2019, ANEEL has already indicated no change in the weighted average cost of capital (WACC) used to calculate the tariff increase, maintaining it rate at 8.09%, which will contribute to lower volatility in the company's future cash flow.

Large capital spending to achieve regulatory targets

EDP - Sao Paulo's capacity to meet the regulatory EBITDA indicated by ANEEL depends on the company's ability to meet the efficiency levels related to operating costs and energy losses. The company's nontechnical energy losses at the low-tension grid (mostly related to illegal electricity connections by consumers) have seen a substantial decrease, reaching 8.46% in December 2018, down from 9.57% a year earlier. This reduction reflects the company's larger capital spending on grid upgrades, connection of new clients and equipment replacement for remote monitoring in the range of BRL250 million-BRL310 million per year since 2016.

Exhibit 3

Notable improvements in reduction in nontechnical losses



[1] Last 12 months average
Source: EDP - Sao Paulo

The ratings base case takes into consideration capital spending in the range of BRL300 million-BRL400 million per year through the next review cycle until 2023, to support further reduction in energy losses and sustain improvement in other qualitative targets. We assume this will be financed with a combination of internal and external cash generation so that the company's ratio of debt to total capitalization remains in the 55%-60% range.

Low carbon transition risk

EDP - Sao Paulo has low carbon transition risk within the utility sector because it is an electricity distribution utility with no generation ownership. All energy costs associated with power procurement, including those that are generated from carbon sources, are fully passed through to the customers with an effective cost recovery mechanism. Although transmission and distribution companies generally have low carbon transition risk, a sharp growth in rooftop solar and energy efficiency among customers in EDP - Sao Paulo's service territory could eventually result in a decline in the company's volumes. Risks associated with this scenario are mostly centered on the potential for stranded assets and affordability concerns in light of tariff increases that may be needed to compensate for the grid investments. However, we currently do not see broader national energy policies or the influence of regional market forces to have a material impact on the company's credit profile over the next three to five years.

Liquidity analysis

EDP - Sao Paulo reported a cash position of BRL152 million as of December 31, 2018, with BRL455 million of debt coming due 2019, comprising the maturity of its fourth issuance of promissory notes and other bank loans. The low cash buffer to short-term debt is mainly a result of the high regulatory liability payments in the last two years.

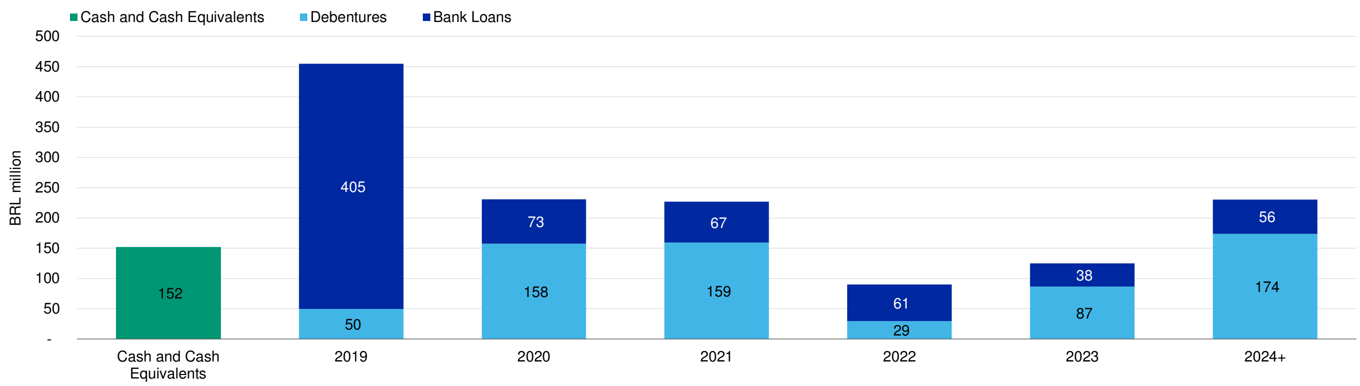
For this year, we expect the combination of favorable regulatory decisions, coupled with a gradual improvement in Brazil's macroeconomic fundamentals, to further help the company improve its liquidity buffer and sustain adequate credit metrics through the next tariff review cycle starting in November 2019. We expect higher operating cash flow generation after capital spending in the range of BRL100 million-BRL150 million in 2019.

EDP - Sao Paulo has a track record of high dividend distribution supported by its resilient cash flow generation. Although dividend payout decreased to around 60% in the last year to preserve liquidity in face of high working capital needs and capital spending, we assume the company will continue to distribute most of its net earnings to its parent, but with the option to retain distributions to preserve an adequate cash position in case of enhanced market volatility.

Like other Brazilian companies, EDP - Sao Paulo does not have committed banking facilities to face any unexpected cash disbursements. Although the company will face relatively high refinancing needs over the next 12 months, we expect its proven execution track record and sound access to the local bank and capital markets as part of the EDB group to ensure the company's ability to refinance its short-term obligations.

Exhibit 4

High refinancing needs in the short term mitigated by sound access to capital markets



Source: EDP - Sao Paulo

Rating methodology and scorecard factors

The outcome of our 12-18-month forward-looking view of the Regulated Electric and Gas Utilities methodology grid is Baa3, which is two notches above EDP - Sao Paulo's current rating, reflecting its strong credit metrics and market position.

Exhibit 5

Rating factors

EDP - Sao Paulo Distribuição de Energia S.A.

Regulated Electric and Gas Utilities Industry Grid [1][2]	Current FY 12/31/2018		Moody's 12-18 Month Forward View As of 4/01/2019 [3]	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	Ba	Ba	Ba	Ba
b) Consistency and Predictability of Regulation	Ba	Ba	Ba	Ba
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Ba	Ba	Ba	Ba
b) Sufficiency of Rates and Returns	Ba	Ba	Ba	Ba
Factor 3 : Diversification (10%)				
a) Market Position	Baa	Baa	Baa	Baa
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.7x	Baa	4.5x - 4.9x	A
b) CFO pre-WC / Debt (3 Year Avg)	34.1%	Aa	25% - 30%	A
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	23.8%	A	10% - 13%	Baa
d) Debt / Capitalization (3 Year Avg)	51.0%	Baa	55% - 59%	Ba
Rating:				
Grid-Indicated Outcome Before Notching Adjustment		Baa2		Baa3
HoldCo Structural Subordination Notching				0
a) Indicated Outcome from Grid				Baa3
b) Actual Rating Assigned				Ba2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2018; [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.
Source: Moody's Financial Metrics™

Ratings

Exhibit 6

Category	Moody's Rating
EDP SAO PAULO DISTRIBUICAO DE ENERGIA S.A.	
Outlook	Stable
Corporate Family Rating	Ba2
Senior Unsecured -Dom Curr	Ba2
NSR Corporate Family Rating	Aa1.br
NSR Senior Unsecured	Aa1.br
ULT PARENT: EDP - ENERGIAS DE PORTUGAL, S.A.	
Outlook	Stable
Issuer Rating	Baa3
Bkd Sr Unsec MTN -Dom Curr	(P)Baa3
Jr Subordinate -Dom Curr	Ba2
Commercial Paper -Dom Curr	P-3
PARENT: EDP - ENERGIAS DO BRASIL S.A.	
Outlook	Stable
Corporate Family Rating -Dom Curr	Ba2
Senior Unsecured -Dom Curr	Ba3
NSR Corporate Family Rating	Aa2.br
NSR Senior Unsecured	A1.br

Source: Moody's Investors Service

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