

Credit Opinion: Bandeirante Energia S.A.

Global Credit Research - 22 May 2012

Sao Paulo, Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
Subordinate -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa1.br
NSR Subordinate -Dom Curr	Aa2.br
Ult Parent: Energias de Portugal, S.A.	
Outlook	Negative
Issuer Rating	Ba1
Senior Unsecured -Dom Curr	Ba1
Commercial Paper -Dom Curr	NP
Parent: EDP - Energias do Brasil S.A.	
Outlook	Stable
Issuer Rating -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa2.br

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Key Indicators

[1]Bandeirante Energia S.A.

ACTUALS	LTM 1Q2012	2011	2010	2009	2008	2007
(CFO Pre-W/C + Interest) / Interest Expense	5.0x	5.8x	7.0x	8.8x	6.2x	7.7x
(CFO Pre-W/C) / Debt	42.2%	47.9%	47.4%	51.5%	63.3%	82.3%
(CFO Pre-W/C - Dividends) / Debt	7.5%	14.8%	22.8%	22.6%	13.1%	75.5%
Debt / Capitalization	47.3%	50.1%	52.7%	50.5%	47.5%	46.2%

[1] All ratios calculated in accordance with the Regulated Electric and Gas Utilities Rating 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

- Solid credit metrics
- Resilient access to the local banking market
- Lower tariffs expected from the third tariff review
- The level of support of its parent company, EDB

Corporate Profile

Bandeirante Energia S.A., headquartered in São Paulo, Brazil, is an electricity distribution utility fully controlled by EDP - Energias do Brasil (EDB) that serves around 1.5 million clients in the eastern portion of the industrialized state of São Paulo. In the last twelve months ended March 31, 2012, Bandeirante reported net revenues of BRL2.4 billion (USD1.4 billion) on sales of 14.7 GWh, representing around 3.7% of the electricity consumed in Brazil's integrated system.

SUMMARY RATING RATIONALE

The Baa3 rating for Bandeirante reflects the stable and predictable cash flows from its regulated distribution business, strong credit metrics for its rating category, the overall investment grade credit profile of the group, EDP-Energias do Brasil and its resilient access to the local capital markets. The ratings are constrained by the high dividend pay-out ratio, the relatively sizeable capital expenditures and the evolving Brazilian regulatory environment. The recent rating downgrades and the placement of the rating outlook to negative of its ultimate major shareholder EDP Portugal further constrains the ratings.

Recent Events

On February 16, 2012, Moody's downgraded Energias de Portugal SA (EDP), its finance subsidiary EDP Finance BV (EDP Finance) and its Spanish subsidiary, Hidroelectrica del Cantabrico (HC Energia) to Ba1 from Baa3. Moody's has also downgraded the rating of EDP and EDP Finance's EMTN program to (P)Ba1 from (P) Baa3. Concurrently, Moody's downgraded the short-term ratings of EDP, EDP Finance and HC Energia to Not-Prime from Prime-3. The assigned outlook on all affected ratings was negative.

These announcements followed Moody's earlier decision to downgrade the Republic of Portugal's sovereign rating to Ba3 with a negative outlook from Ba2 with a negative outlook, as announced on 13 February 2012.

On July 08, 2011 Moody's downgraded the senior unsecured ratings of EDP - Energias de Portugal SA, its finance subsidiary EDP Finance BV ("EDP Finance") and its Spanish subsidiary, Hidroelectrica del Cantabrico ("HC Energia") to Baa3 from Baa1. Moody's also downgraded the rating of EDP's and EDP Finance's Euro Medium Term Note program to (P)Baa3 from (P)Baa1. The outlook assigned to the ratings was negative.

This rating action concluded the review initiated on 6 April 2011 and followed the earlier downgrade of the rating of the government of the Republic of Portugal ("RoP") to Ba2 with a negative outlook from Baa1, on review for downgrade.

On April 6, 2011 Moody's placed the Baa1/P-2 senior unsecured ratings of Energias de Portugal SA (EDP) under review for possible downgrade.

On March 17, 2011 Moody's downgraded the senior unsecured ratings of Energias de Portugal SA (EDP) to Baa1 from A3 (on review for downgrade). The outlook was changed to stable.

DETAILED RATING CONSIDERATIONS

HISTORICALLY STRONG CREDIT METRICS

Bandeirante has steadily posted strong profitability and cash flows over the past five years driven by the fairly stable nature of its regulated distribution business. In this period, cash drains mainly consisted of capital expenditures and the distribution of dividends, which have been in line with the company's internal cash generation. This is evidenced by the steady financial leverage as measured by the three-year average CFO-WC over Debt ratio of 48.9% and the

three-year average retained cash flow (CFO Pre-WC - dividends) over debt ratio of 22.6% in the same period.

As expected, Bandeirante recorded a strong operating performance in 2011, which was, however, not as good as in 2010. CFO - WC (Cash from operations before changes in working capital) declined to BRL 381 million in 2011 down from BRL 432 million in 2010. The 3% volume sales growth was the major positive factor in this performance which, however, was largely offset by higher sales in the spot market at lower tariffs and to a lower extent increased operating expenses mainly consisting of the third party services and labor expenses. This largely explains the reduction in operating margins as measured by EBITDA, which does not include interest income, of BRL 481.4 million in 2011 (20% over net sales) down from BRL 482.9 million in 2010 (21.4%).

In spite of this slight deterioration in operating margins, credit metrics remained very strong for the rating category. As a matter of fact, CFO - WC over debt ratio improved to 47.9% in 2011 up from 47.4% in 2010, which was largely due to a significant reduction in the company's cash position from BRL 364 million in 2010 to BRL 192 million in 2011 to fund the cash shortfalls. Nevertheless, Bandeirante's financial position is very strong for its rating category particularly with respect to its cash flow coverage metrics.

Bandeirante's profitability was further impaired by extraordinary expenses of BRL 77 million related to an unfavorable court decision on a judicial dispute, which dates back to the eighties. As a result, Bandeirante posted a lower net profit of BRL 222.9 million in 2011 down from BRL 278.2 million in 2010.

While slightly weaker, the debt capitalization ratio has remained stable over the past five years, which stems from the company's historical high dividend pay-out ratio close to 95% over the past five years. As of March 31, 2012, Bandeirante showed a debt to capitalization ratio of 47.3%, below the previous three year average of 51.1%.

CREDIT METRICS TO DETERIORATE GOING FORWARD

We forecast that Bandeirante will present weaker credit metrics within our three-year projections in comparison with the previous five years. FFO (Funds from operations) is expected to dramatically decrease already in 2012 from the combination of increased costs and the tariff freeze imposed by the regulator to Bandeirante since October 2011 to be valid until October 2012 when the company will be subject to the third tariff review.

This tariff freeze was an alternative the regulator used to compensate for the fact that the company was initially scheduled to have its electricity tariffs reviewed in October 2011. As the methodology and operational procedures of the third tariff review were not published by the regulator in 2011 as previously scheduled, the tariff review to be applied to Bandeirante was postponed to October 2012. The regulator applied the same tariff freeze procedure to all distribution companies initially scheduled to have their electricity tariffs reviewed in 2011 in accordance with the operational procedures of the third tariff review.

We forecast that the company's revenues will be reduced by around 0.5% in 2012, as a result of the combination of a reduction of around 7% from the application of the new operational procedures of the third tariff review (October 2012) partly offset by a positive 5% related to the pass-through of increased non-manageable costs, mainly consisting of more expensive electricity acquired from generators and transmission related expenses.

Our projections indicate that CFO before changes in working capital will average around BRL 190 million or 21.9% over total debt over the next three years down from the previous 48.9% three-year average, while interest coverage should be around 3.3x in the same period. We foresee that the company will moderate the distribution of dividends to a much lower level, which we estimate will be around 25% of net profit. As a result, we expect that the RCF over debt ratio will average 19% over the next three years.

The reduction in CFO will mostly come from the third tariff review to be applied in October 2012, which we expect to be partly tempered by lower interest expenses and lower pressure on working capital needs. The Brazilian base interest rate (SELIC) is running at 9% and some economists forecast a further reduction in the months ahead with the expectation that this lower level will remain at these levels for a prolonged period.

Given the expected lower dividend pay-out ratio, the debt capitalization ratio is forecasted to gradually improve from 2012 through 2014 in comparison with the historical ratios, which virtually remained unchanged in the previous five years as the company's pay-out ratio was close to 95%.

The projected credit metrics will dramatically decrease going forward but expected to be compatible for the Baa3 issuer rating but now at the low end of this rating category. The key factor will be how the company will balance the

payment of dividends in the face of lower cash from operations from the third tariff review. We will closely monitor the company's performance to evaluate how the company will balance the interests of shareholders and creditors.

HIGHER VOLATILITY IN FFO FROM THE IMPLEMENTATION OF IFRS

Unlike the Brazilian GAAP accounting method, the IFRS does not recognize the concept of regulatory assets and liabilities. As a result, going forward Moody's expects higher volatility in cash flow parameters as measured by funds from operations (FFO). Any change in the so-called regulatory assets and liabilities will be recognized either as an expense or income in the profit and loss statement.

The change of the accounting principles from the Brazilian GAAP to the IFRS (International Financial Reporting Standards) for Bandeirante's 2009, 2010 and 2011 financial statements does not interfere with Moody's comparative analysis of the utility's cash flow statements for these years against the previous years. This stems from the fact that the main cash flow parameter used in Moody's methodologies for electric utilities, cash from operations before changes in working capital needs (CFO Pre-WC), already captures any variations in regulatory assets and liabilities.

LOWER TARIFFS FROM THE TARIFF REVIEW IN OCTOBER 2012

In October 2012, the regulator ANEEL will apply the new methodology for tariff review to Bandeirante, which will transfer productivity gains to consumers with effects retroactive to October 2011. The application will also apply a lower WACC in the face of lower capital costs (equity and borrowings) among the Brazilian electricity distribution companies.

At the end of last year, ANEEL signaled a significant reduction of tariffs for all Brazilian electricity distribution companies when it placed for public hearing the new procedures for the third electricity tariff review, to be implemented from 2011 through 2013. According to the Brazilian electricity regulatory model all Brazilian electricity distribution companies are subject to periodic tariff reviews every four to five years in order to transfer any productivity gains to consumers.

Based on public information available at ANEEL's website, we expect that electricity tariffs will eventually be reduced between 5% and 7%, with a reduction in EBITDA within the 25-30% range.

LEVEL OF SUPPORT OF EDP PORTUGAL

The ratings assigned for the EDB group also factor in the ownership of its parent company, EDP Portugal (Ba1; negative outlook). While EDP does not guarantee EDB's debt, the parent expects that its subsidiaries will remain financially self-sustainable, as stated in its published policies. Moody's believes that the Brazilian operations of EDP play an important role in the group's growth strategy. The recent rating downgrades and current negative outlook could potentially limit the ability of EDP Portugal to potentially step in to support its subsidiaries with a material undertaking in case of financial distress.

In this context, Moody's believes that ownership by EDP does not support a one notch of uplift of the rating on the global scale. On the other hand, Bandeirante's Baa3 issuer rating is largely based on EDB's overall investment grade characteristics on a consolidated basis supported by the steady improvement in credit metrics in the past four years and a conservative financial management.

Moody's believes that EDP Portugal will continue to support the activities of EDB by preserving the current strong capital structure of its Brazilian subsidiary. However, Moody's will continue to monitor the evolution of the creditworthiness of EDP Portugal and the potential impact this could have on the financial strength of EDB.

We have firm grounds to believe that the Brazilian subsidiaries, mainly the distribution companies, are to a large extent insulated from any potential credit deterioration of their parent company. This results from regulatory oversight and existing financial covenants embedded in most of the debt contracts, which prevent those companies from increasing their leverage over a certain agreed limit.

IMPROVEMENT IN THE BRAZILIAN REGULATORY ENVIRONMENT

An important factor constraining Bandeirante's rating has been the Brazilian regulatory framework, which has a history of being unpredictable but has undergone substantial change over the past several years. The electricity regulatory model implemented in 2004 has mitigated the uncertainties brought about by constant changes in the Brazilian regulatory framework over the past two decades. The current model provides a more supportive

environment for acceptable rates of return since the current rules for electric utilities are transparent and technically driven, thus increasing predictability of return on invested capital. In light of this relevant improvement, Moody's lifted the Brazilian regulatory framework to a higher category level in August 2008.

Despite the upgrade in the supportiveness of the local regulatory environment, we still believe there is a lower assurance of timely recovery of costs and investments in Brazil since the new framework has not yet experienced a prolonged period of high inflation, exchange rate devaluation or electricity rationing. In our evaluation of these factors we also took into consideration potential future electricity shortages due to a tight reserve margin, limited independence of the regulator and minimal jurisprudence backing the new regulatory framework.

Liquidity

Bandeirante has an adequate liquidity profile supported by its resilient access to the capital and bank markets and cash availability of BRL188 million as of March 31, 2012, which compares favorably with its short-term debt position of just BRL87 million.

In 2012, Moody's projects CFO of BRL 140 million, which along with its solid cash position is expected to allow the company to comfortably meet most of its cash needs. The main cash outlays will consist of capital expenditures of BRL160 million and the repayment of short-term debt of BRL 87 million. Moody's expects that these cash requirements will be funded with a combination of internal cash generation and additional debt issuance.

We deem the liquidity standing of EDB on a consolidated basis as very adequate. At December 31, 2011, EDB reported a sizeable consolidated cash position of BRL 896 million, which comfortably covers consolidated short-term debt of BRL 660 million. This strong cash position along with estimated CFO of around BRL1.2 billion will substantially support EDB's planned capital expenditures of around BRL1 billion and dividends of approximately BRL500 million. We forecast that EDB will need to raise around BRL 700 million not just to meet its expected cash shortfalls in 2012 but also to maintain its current strong cash position.

Additionally, based upon management's provided information, EDB has around BRL900 million pre-approved long-term loan commitments from the BNDES, of which just BRL300 million has been used. These resources are targeted at supporting the capital expenditure program of EDB's operating subsidiaries. Given its proven resilient access to the local banking and capital markets, EDB could also access these markets to complement its borrowing needs.

Corporate Governance

Bandeirante's rating considers that 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. While its shares are only traded on the São Paulo stock exchange, the company has undertaken several steps beyond what is legally required to adapt the U.S. Sarbanes-Oxley act as part of its commitment of practicing superior standards of corporate governance.

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, this committee is non-permanent and convened only when requested by shareholders.

Rating Outlook

The stable outlook derives from Moody's expectation that Bandeirante will prudently balance capital expenditures and the distribution of dividends in the light of an expected lower cash generation from the application of the third tariff review so that the company's credit metrics remain compatible with the Baa3 rating category.

The stable outlook also reflects Moody's expectation that EDB on a consolidated basis will continue to prudently manage capital expenditures in tandem with its subsidiaries' cash flow capacity and will efficiently handle its liquidity position so that retained cash flow remains above 13% of total debt on a consolidated basis. Moody's expects that EDP Portugal will continue to support its subsidiaries by preserving their current liquidity position and low leverage.

What Could Change the Rating - Up

Given the expected deterioration in the company's credit metrics over the medium horizon an upgrade rating action is very unlikely. Quantitatively, an upgrade could result from retained cash flow to total debt of above 20% and interest coverage above 4.0x on a sustainable basis along with Moody's expectation that EDP Portugal will not undertake any actions to materially alter the current capital structure of EDB.

What Could Change the Rating - Down

A downgrade of Bandeirante could be triggered by a material deterioration of its credit metrics so that RCF over debt ratio is below 13% and interest coverage is below 3.0x on a sustainable basis. A downgrade of EDB's ratings could trigger a downgrade of Bandeirante, which could occur if the consolidated RCF over debt ratio is below 13% and interest coverage is below 3.0x on a sustainable basis. Deterioration in the level of supportiveness of the Brazilian regulatory environment for regulated utilities could also prompt a negative rating action for Bandeirante and EDB.

Other Considerations

The principal methodology used in rating Bandeirante was Moody's Regulated Electric and Gas Utilities Rating Methodology, published in August 2009 and available on www.moody.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Rating Factors

Bandeirante Energia S.A.

Regulated Electric and Gas Utilities	Current 12/31/2011		Moody's 12 - 18 month Forward View	
Factor 1: Regulatory Framework (25%)	Measure	Score	[1]Measure	Score
a) Regulatory Framework (25%)		Ba		Ba
Factor 2: Ability to Recover Costs and Earn Returns (25%)		Ba		Ba
Factor 3: Diversification (10%)				
a) Market Position (10%)		Ba		Ba
b) Generation and Fuel Diversity (0%)				
Factor 4: Financial Strength, Liquidity & Financial Metrics (40%) [2]				
a) Liquidity (10%)		Baa		Baa
b) CFO pre-WC + Interest / Interest (7.5%) (3yr Avg)	7.0x	Aa	2.9x - 3.9x	Baa
c) CFO pre-WC / Debt (7.5%) (3yr Avg)	48.9%	Aaa	17.8% - 26.1%	Baa
d) CFO pre-WC - Dividends / Debt (7.5%) (3yr Avg)	20.2%	A	14.9% - 23.6%	A
e) Debt / Capitalization or Debt / RAV (7.5%) (3yr Avg)	51.1%	Baa	48.0% - 48.3%	Baa
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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