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CREDIT OPINION
23 April 2018

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.

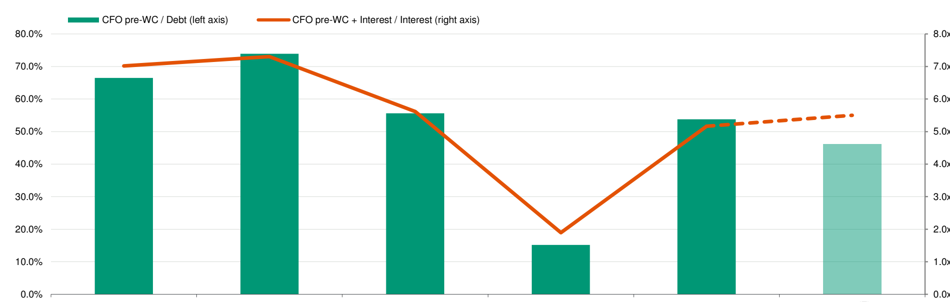
## Update Following Outlook Change to Stable

## Summary Rating Rationale

EDP- Sao Paulo Distribuição de Energia S.A. (EDP- Sao Paulo)'s Ba2/Aa1.br corporate family ratings reflect: (i) the relatively stable and predictable nature of its cash flows derived from a distribution concession that is valid through October 2028, (ii) strong credit metrics for the rating category, evidenced by the cash from operations before changes in working capital (CFO pre-WC) to Debt ratio of 54% and Interest Coverage Ratio of 5.2x in 2017, and (iii) an evolving regulatory environment with track record of support aimed to provide timely relief to the financial risk of electricity distribution companies. Continued access to the local capital markets and the implicit support from its parent holding company EDP - Energias do Brasil S.A. (EDB; Ba2, stable) are also important rating considerations.

Constraining EDP - Sao Paulo's ratings are: (i) an expected leverage increase to support capital investments to upgrade the network and prevent losses before the next tariff review cycle in 2019, and (ii) a track record of high dividend distributions to the parent. The rating remains somewhat constrained by Brazil's Goverment rating (Ba2, stable), given the intrinsic links between the company and the credit quality of sovereign due to its regional customer base.

Exhibit 1
**Leverage metrics will moderately increase in 2018, revenue growth and lower interest rates**




*Sources: Moody's Investor Services; Moody's projection for 2018.*

## Credit Strengths

- » Robust cash flow generation expected for 2018, supported by lower regulatory liabilities
- » Strong credit metrics
- » Implicit support of EDB

## Credit Challenges

- » Track record of high dividend payout
- » High investment requirements to complete upgrades in the grid ahead of next tariff review cycle

## Rating Outlook

The stable outlook for EDP - Sao Paulo reflects the stabilization of Brazil's sovereign rating outlook, as well as Moody's expectation that metrics will remain well positioned for the rating category.

## 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 outlook stabilization would also depend on sustained improvement in the relevant credit metrics, the 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 CFO pre-WC to total debt ratio stays sustainably above 55%, and
- » The interest coverage remains above 5.5x on a sustainable basis.

## Factors that Could Lead to a Downgrade

Downward rating pressure could come with a deterioration in EDP - Sao Paulo's liquidity position, resulting from weaker than anticipated 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 exert downward pressure on EDP - Sao Paulo's rating Quantitatively, the ratings could be downgraded if we see a sustainable deterioration in credit metrics, so that:

- » The CFO pre-WC-to-Debt falls below 25%, or
- » The interest coverage stays sustainably below 4.0x

## Key Indicators

Exhibit 2

**KEY INDICATORS [1]**

**EDP - Sao Paulo Distribuição de Energia S.A.**

| | 12/31/2017 | 12/31/2016 | 12/31/2015 | 12/31/2014 | 12/31/2013 |
|---|---|---|---|---|---|
| CFO pre-WC + Interest / Interest | 5.2x | 1.9x | 5.6x | 7.3x | 7.0x |
| CFO pre-WC / Debt | 53.8% | 15.2% | 55.6% | 73.9% | 66.5% |
| CFO pre-WC – Dividends / Debt | 48.8% | -12.9% | 38.8% | 48.3% | 61.0% |
| Debt / Capitalization | 50.5% | 46.0% | 47.0% | 44.8% | 36.4% |

*[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™*

## Corporate Profile

EDP Sao Paulo, headquartered in São Paulo, Brazil, is an electricity distribution utility fully controlled by EDP Energias do Brasil (EDB; Ba2, stable), 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 São Paulo State, a highly industrialized area. In 2017, EDP Sao Paulo reported net revenues of BRL3.7 billion, which does not include construction revenues of BRL270 million (as per Moody's adjustments), on sales of 16.424 GWh, constituting around 3.5% of the electricity consumed in Brazil's integrated system.

## Detailed Rating Considerations

### TRACK RECORD OF RESILIENT CREDIT METRICS DESPITE ECONOMIC VOLATILITY

In 2017, electricity demand recovered after two consecutive years of recession with sales volume increasing to 16.424 GWh, 4.1% up 2016 levels. Additionally, EDP - Sao Paulo also improved its energy balance in 2017, reducing the exposure to over contracted energy volumes to the 100% and 105% range, which is in line with the regulatory threshold. This percentage was at 111.9% in 2016 and at 109% in 2015, leading the company to sell the surplus at relatively lower spot prices, contributing to deterioration in operating margin.

As a result, the company's credit metrics improved in 2017, as indicated by a CFO pre-WC to total debt ratio of 54% and an interest coverage ratio of 5.2x for 2017; up from 15% and 1.9x, respectively, in 2016. On the other hand, EDP - Sao Paulo posted negative cash flow from operations of BRL159 mi in 2017 vs. positive BRL783 million in 2016 (as per Moody's adjustments), mostly driven by the payment of regulatory liabilities. In 2018, we do not anticipate similar working capital pressures.

Regulated electric utilities are positioned to benefit the most from the gradual industrial production recovery and decline in unemployment. We forecast that electricity consumption will resume growth in the 2%-3% range in the next 12 to 18 months. The principal factors that could temper our view are low water reservoir levels, which could prompt energy-saving campaigns that limit demand growth for distribution companies; a slowdown in industrial output leading to an increase in unemployment; and the possibility that political uncertainty around the 2018 elections will put a damper on the economic recovery.

### REGULATORY ENVIRONMENT EVOLVING POSITIVELY

Recent regulatory decisions aimed to mitigate the impact of high energy costs and of 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.

EDP - Sao Paulo has received timely regulatory tariff adjustments that helped to mitigate the impact of high energy costs during the economic recession. In February 2015, ANEEL, Brazil's regulator approved an extraordinary tariff adjustment for EDP Sao Paulo of 32.18%, which helped reduce the negative effects of higher energy costs due to 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 return on a Net Regulatory Asset Base (RAB) of BRL1.7 billion.

For EDP - Sao Paulo next review cycle scheduled in October 2019, ANEEL has already indicated no change on the WACC used to calculate tariff increase, maintaining this rate at 8.09%, which will contribute to lower volatility in the company's future cash flows. Nevertheless, the company still needs to complete large capital expenditures to comply with regulatory targets set forth in the 2014-2019 review cycle.

### LARGE CAPITAL EXPENDITURES & DIVIDENDS CONSTRAINT LEVERAGE REDUCTION

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 that will likely translate into larger capital expenditures in 2018 and 2019. EDP - Sao Paulo's non technical energy losses at the low tension grid reached 9.57% in 2017, down from 9.98% in 2016, but still above the 9.19% regulatory target for that year. In our base case scenario, we consider capital expenditures in the range of BRL240 million to BRL320 million per year through 2019, mainly on grid upgrades and equipment replacement that will support further reduction in energy losses. We assume this will be financed with a combination of internal and external cash generation, so that the company's debt to total capitalization ratio remains in the 50% - 60% range.

EDP Sao Paulo also has a track record of high dividend distribution supported by its resilient cash flow generation. Moody's considers that the company will continue to distribute large dividends to its parent company, but will retain cash to preserve an adequate liquidity in case of enhanced market volatility.

## Liquidity Analysis

EDP - Sao Paulo's reported a cash position of BRL133 million as of December 31,2017, with BRL237 million of debt maturities in 2018 (as per Moody's adjustments). Despite the low cash cushion, which is mainly due to last year's high regulatory liability payments, we anticipate positive free cash flow generation in the range of BRL100 million to BRL120 million over the next 12 months, as a result of lower working capital requirements and moderate dividend payout.

We expect EDP Sao Paulo will sustain its adequate liquidity profile following the 7th and 8th debentures issued in 2017, amounting approximately BRL 250 million, as they lengthened the company's amortization schedule with maturities in 2022 and 2021, respectively.

The combination of favorable regulatory decisions coupled with a gradual improvement in Brazil's macroeconomic fundamentals will further help the company improve its liquidity cushion and sustain adequate credit metrics through the next tariff review cycle starting in October 2019.

Like other Brazilian companies, EDP Sao Paulo does not have committed banking facilities to face any unexpected cash disbursements, however we have deemed the company's liquidity as adequate given the fact that its debt is solely concentrated in the long term and also its proven access to capital markets, intrinsically benefiting from being part of the EDB group.

## Rating Methodology and Scorecard Factors

The grid implied rating from Moody's 12-18 month forward view of the Regulated Electric and Gas Utilities Industry methodology is Baa3, which is two notches above EDP Sao Paulo's current rating.

Exhibit 3
**Rating Factors**
**EDP - Sao Paulo Distribuição de Energia S.A. (EDP Sao Paulo)**

| Regulated Electric and Gas Utilities Industry Grid [1][2] | Current FY 12/31/2017 | | Moody's 12-18 Month Forward View As of 4/12/2018 [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) | 4.2x | Baa | 3.5x - 5.0x | Baa |
| b) CFO pre-WC / Debt (3 Year Avg) | 43.4% | Aaa | 25% - 45% | Aa |
| c) CFO pre-WC – Dividends / Debt (3 Year Avg) | 27.9% | Aa | 8% - 16% | Baa |
| d) Debt / Capitalization (3 Year Avg) | 48.0% | Baa | 50% - 60% | Ba |
| **Rating:** | | | | |
| Grid-Indicated Rating Before Notching Adjustment | | Baa2 | | Baa3 |
| HoldCo Structural Subordination Notching | | | | |
| a) Indicated Rating from Grid | | Baa2 | | 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 12/31/2017; [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 4

| Category | Moody's Rating |
|---|---|
| **EDP SAO PAULO DISTRIBUICAO DE ENERGIA S.A.** | |
| Outlook | Stable |
| Corporate Family Rating | Ba2 |
| NSR Corporate Family Rating | Aa1.br |
| Senior Unsecured -Dom Curr | Ba2 |
| 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 |
| NSR Corporate Family Rating | Aa2.br |
| Senior Unsecured -Dom Curr | Ba3 |
| NSR Senior Unsecured | A1.br |

*Source: Moody's Investors Service*

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CLIENT SERVICES

| | |
|---|---|
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