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Research Update:

Espirito Santo Centrais Eletricas 'BB' And 'brAA-' Ratings And Bandeirante Energia 'brAA-' Ratings Affirmed

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Overview

- We expect EDP Brasil to maintain comfortable credit metrics over the next few years thanks to the recent equity injection, while its subsidiaries, power distributors Bandeirante and Escelsa, continue to benefit from the monetization of regulatory assets throughout 2016.
- We're affirming our 'BB' global scale and 'brAA-' Brazil national scale ratings on Escelsa and our 'brAA-' rating on Bandeirante.
- The negative outlook on both companies reflects that of the sovereign rating on Brazil, indicating that we will downgrade Bandeirante and Escelsa if there is a similar rating action on Brazil.

Rating Action

On Sept. 23, 2016, S&P Global Ratings affirmed its 'BB' global scale and 'brAA-' Brazil national scale ratings on Espirito Santo Centrais Eletricas S.A. (Escelsa). The outlook on both ratings remains negative. Escelsa's 'bb+' stand-alone credit profile (SACP) remains unchanged. At the same time, we affirmed our 'brAA-' rating on the sister company, Bandeirante Energia S.A. (Bandeirante). The outlook also remains negative.

Rationale

The affirmation reflects Bandeirante and Escelsa's ratings limitation to the sovereign credit rating on the Federative Republic of Brazil (global scale: BB/Negative/B; national scale: brAA-/Negative/--), where they operate. As regulated utilities, in our view, they could be subject to intervention from the government, such as rate freezes, which could jeopardize their ability to continue generating cash, as already happened in other countries.

We analyze Bandeirante and Escelsa based on EDP Energias do Brasil S.A.'s (EDP Brasil) consolidated figures, given our view that the group adopts an integrated financial strategy and actively manages its subsidiaries' operations. Therefore, we take into consideration the importance of the distribution companies to EDP Brasil and the Brazilian operations to the ultimate controlling shareholder, EDP - Energias de Portugal S.A. (EDP; BB+/Positive/B).

EDP Brasil's main cash flow contributor is its power generation segment. The

latter consists of 2,726 megawatts (MW) of installed capacity, about 74% of which is hydro based. Pecem, a coal plant in which the group acquired the remaining stake that it didn't already own last year, generates the remaining portion of EDP Brasil's electricity. Given the severe drought in Brazil during 2015, domestic hydro plants' operating and financial performance suffered because they were forced to purchase energy in the spot markets at high prices to compensate for energy shortfalls. But the group adhered to the Law 13,203-- which determines the insurance categories for hydrology risk-- for its hydro plants with power purchase agreements in the regulated market, which works as an insurance for higher spot prices when hydrology weakens, helping to stabilize the group's cash flows from this segment. EDP Brasil also has stakes in three hydro plants, two of which were recently constructed and are already operating, while the third one, the São Manoel plant, is still under construction. The construction and startup of the Santo Antônio do Jari and Cachoeira Caldeirão plants was within budget and original schedule, respectively, which underscores the group's proven ability to plan and execute its investments to expand capacity, in our view.

The group also operates in the distribution segment through Bandeirante, which serves 28 cities in the state of Sao Paulo, and through Escelsa, which serves 70 municipalities in the state of Espirito Santo. In our view, the Brazilian distribution segment benefits from a regulatory framework that seeks to minimize the mismatches between electricity rates and the costs effectively incurred, including power purchases and transmission. However, temporary mismatches can occur, as seen in the R\$734.8 million in net regulatory assets that Bandeirante and Escelsa accumulated in 2015. Both companies were able to fully convert these assets into cash at the end of the first half of 2016 as a result of lower electricity costs and proceeds from the rate flag mechanism. By that time, Escelsa reported R\$164.4 million of net regulatory assets while Bandeirante presented R\$173.1 million in net regulatory liabilities, indicating that the latter collected excess cash that it will have to return to its clients upon the October 2016 rate readjustment.

Overall, Bandeirante and Escelsa are in compliance with the regulatory indicators for the quality of their services, except for Bandeirante's system average interruption duration index (DEC), which is slightly higher than the regulatory standards due to severe climate conditions. In the next few years, we believe the group will target its investments in the distribution segment to improve both subsidiaries' DEC and the system average frequency interruption index (FEC), and to reduce electricity losses, which increased on a percentage basis due to Brazil's recession.

Escelsa recently had its seventh rate review, which we view as positive for the company because of the recognition of higher electricity losses in its rates, which will be flat at 11.45% for the next three years. In addition, the review reevaluated Escelsa's regulatory asset base that increased its regulatory EBITDA by R\$102 million, which should strengthen its cash flow generation in the next few years.

Unlike in the past few years, the electricity consumption has slowed since the

second half of 2015, which led to the oversupply of power contracts because the distributors' purchases of electricity are surpassing their concession areas' electricity demand. According to the Brazilian regulation, distributors can incorporate an oversupply cost of up to 5% into their rates. We expect the ongoing discussions between the distributors and the regulator, ANEEL, will help to mitigate the impact of the power glut. It affects Bandeirante, while Escelsa's electricity purchase is closer to the 105% threshold.

Our base-case scenario for EDP Brasil considers the following factors:

- Hydrology shouldn't weaken the group's generation segment.
- The Pecem coal plant to reach availability ratios of at least 90% of the regulatory requirement.
- Combined electricity consumption in areas that the distributor subsidiaries serve will decrease by about 5% in 2016 (about 2% for Bandeirante and close to 9% for Escelsa) and to grow 2.0%-2.5% (no growth for Bandeirante and about a 5% growth for Escelsa) in 2017.
- A negative rate adjustment for Bandeirante in October 2016 to incorporate the lower electricity costs and sectorial charges in 2016.
- Bandeirante's power oversupply will be above the regulatory threshold in the next few years, which can be mitigated depending on the discussions between the companies and the ANEEL.
- Annual investments of around R\$650 million, mostly to improve the distributors' operating efficiency.
- Dividend payout of about 75% of previous-year net income.
- No incremental debt, following the R\$1.5 billion capital injection.

Based on these assumptions, we expect EDP Brasil to post the following adjusted credit metrics:

	2014A	2015A	2016E	2017E
FFO to debt (%)	9.1	16.0	35-40	25-30
Debt to EBITDA (x)	5.4	3.8	1.5-2.0	2.0-2.5
FOCF to debt (%)	6.3	16.4	20-25	10-15

A: Actual; E: Expected

* Adjusted metrics do not consider the regulatory accounts flowing to the income statement, but we incorporate them in our projections based on our expectation of monetization, in case it is an asset, or as cash outflow, in case it is a liability.

We expect EDP Brasil to keep recovering its regulatory assets in 2016, as it did in the first half of the year when its distributors generated strong cash flows. As Bandeirante's rates currently incorporate higher power costs and contributions to sector-specific funds, we expect a negative rate adjustment in October, following the August 2.97% rate reduction for Escelsa. For the next few years, working capital needs should stabilize, with rates better reflecting costs.

The hydrology risk for the group's generation segment is mitigated by EDP Brasil's policy not to sell 100% of its generation capacity, which provides a cushion for its plants with contracts in the free market, while the Law 13,203 protects the ones dedicated to the regulated market.

Liquidity

We expect the group's liquidity sources to exceed its uses by at least 1.2x in the next 12 months, especially after the recent capital injection of R\$1.5 billion. EDP Brasil has been managing its liabilities well, as seen in its cash position of R\$2.6 billion as of June 30, 2016, which is more than enough to cover debt maturities until the end of 2017. Even if EBITDA were to fall by 15%, we expect the group's sources of liquidity to continue exceeding its uses. We believe that, in case of stress periods, the group has some flexibility to postpone its investments and reduce dividend payout to the minimum, as required by the Brazilian law.

We also view that EDP Brasil has financial flexibility, as seen in its access to the capital markets, the recent debenture issuances at both the holding and operating company levels, and in the subsidized funding from BNDES (the Brazilian Development Bank), which we expect to remain in the next years.

Principal Liquidity Sources:

- Cash position of R\$2.6 billion as of June 30, 2016, which incorporates the recent R\$1.5 billion equity.
- Expected cash flow generation of about R\$1.6 billion in the next 12 months.

Principal Liquidity Uses:

- Debt maturities of around R\$1.6 billion in the next 12 months, considering the prepayments partly from the capital injection proceeds.
- Investments of R\$600 million - \$650 million in the next 12 months.
- Dividend payout of at least 50% in the next 12 months, in line with EDP Brasil's minimum statutory requirement.

Some of Bandeirante and Escelsa's debt require compliance with financial covenants, which are measured at the operating company level:

- Bandeirante: Debt to EBITDA up to 3.5x on every June 30 and December 31 for the fourth issuance and only on December 31 for the fifth issuance.
- Escelsa: Debt to EBITDA up to 3.5x on every December 31.

As of June 30, 2016, both companies were in compliance with their financial covenants, and we expect this to be so for the next 12 months, considering their relatively low leverage metrics.

Group influence

We believe that electricity distributors, Bandeirante and Escelsa, are the most important subsidiaries for EDP Brasil, even considering that the electric power generation segment as a whole is still the main cash contributor.

Despite EDP's recent capital injection, in our view, the importance of the Brazilian operations hasn't diminished, accounting for about 17% of the ultimate parent's consolidated EBITDA.

Outlook

The negative outlook on Bandeirante and Escelsa reflects that on the sovereign, considering that the Brazilian electricity sector is highly regulated, therefore subject to government intervention in a scenario of sovereign default.

Downside scenario

We could downgrade the companies following a similar action on Brazil. For a downgrade in the next 12 months based on their own reasons, EDP Brasil's operations and credit metrics would need to deteriorate, with funds from operations (FFO) to debt below 20% or debt to EBITDA above 5.0x, combined with a free operating cash flow (FOCF) shortfall and less incentives for EDP to support its Brazilian operations. However, we believe such a scenario is unlikely in the short to medium term. A downgrade is also possible following a significant debt-financed acquisition.

Upside scenario

As the ratings on Bandeirante and Escelsa are currently capped by the sovereign ratings, we don't expect an upgrade in the short term. But it's possible if EDP Brasil posts FFO to debt consistently above 30%, debt to EBITDA close to 2.0x, and FOCF to debt above 25%, while EDP Brasil's importance to its parent company rises.

Ratings Score Snapshot

Espirito Santo Centrais Eletricas S.A.

Corporate Credit Rating

Global Scale	BB/Negative/--
National Scale	brAA-/Negative/--

Business risk profile: Satisfactory

- Country risk: Moderately high
- Industry Risk: Intermediate
- Competitive position: Satisfactory

Financial risk profile: Significant

- Cash flow/leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile (SACP): bb+

Group rating methodology:

- Between Escelsa and EDP Brasil: Core
- Between EDP Brasil and EDP: Strategically important

Bandeirante Energia S.A.

Corporate Credit Rating: brAA-/Negative/--

Business risk profile: Satisfactory

- Country risk: Moderately high
- Industry Risk: Intermediate
- Competitive position: Satisfactory

Financial risk profile: Significant

- Cash flow/leverage: Significant

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Adequate
- Management and governance: Neutral
- Comparable rating analysis: Neutral

Group rating methodology:

- Between Bandeirante and EDP Brasil: Core
- Between EDP Brasil and EDP: Strategically important

Related Criteria And Research

Related Criteria

- S&P Global Ratings' National And Regional Scale Mapping Tables, June 1, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
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- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April, 15, 2008

Ratings List

Ratings Affirmed

Espirito Santo Centrais Eletricas S.A.

Corporate Credit Rating

Global Scale

BB/Negative/--

Brazil National Scale

brAA-/Negative/--

Bandeirante Energia S.A.

Corporate Credit Rating

Brazil National Scale

brAA-/Negative/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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