

CREDIT OPINION

23 March 2017

Update
Rate this Research 
RATINGS
**Espirito Santo Centrais Eletricas -
ESCELSA**

Domicile	Espirito Santo, 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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Espirito Santo Centrais Eletricas - ESCELSA

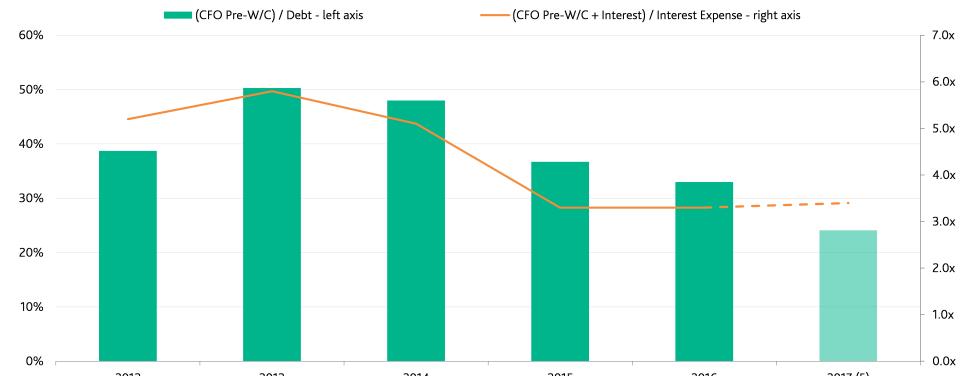
Update following outlook change to stable

Summary Rating Rationale

Escelsa's Ba2 corporate family rating reflects: (i) the relatively stable and predictable nature of its cash flows derived from a distribution concession that is valid through July 2025, (ii) historically strong credit metrics for the rating category, by the three-year average CFO pre-W/C to Debt ratio of 39.3% and Interest Coverage Ratio of 3.8x from 2014 through 2016 (iii) an evolving regulatory environment with recent evidence of supportive 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 EDB (Ba2, stable) are also important rating considerations.

Constraining Escelsa's credit rating are: (i) the challenging operating environment ahead of the company driven by Brazil's economic recession, (ii) the sizeable capital expenditures planned for 2017-2019 to upgrade the network and prevent losses, (iii) a track record of high dividend distributions to the parent company. The rating is further constrained by Brazil's sovereign rating (Ba2, stable).

Exhibit 1
Resilient Credit Metrics to Remain



Credit Strengths

- » Robust cash flow generation in 2016, supported by favorable regulatory decisions.
- » Strong credit metrics, despite high dividends and over-contracted energy volumes
- » Implicit support of EDB

Credit Challenges

- » Losses above the regulatory target level 13.88% vs. 11.45% in 2016
- » Higher-than-historical capital expenditures to reduce losses and upgrade grid
- » Over-contracted energy volumes reached 106.8% in 2016

Rating Outlook

The stable outlook for Escelsa reflects Moody's expectation that the company's credit metrics will remain adequately positioned for its rating category, despite higher capital expenditures planned for the next 12 to 18 months.

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 would also consider the relevant credit metrics, the liquidity profile and the regulatory environment where Escelsa operates.

Factors that Could Lead to a Downgrade

Downward rating pressure could come with a deterioration in Escelsa's liquidity position, resulting from weaker than anticipated growth in its concession area or if there is a perception of reduced support from the regulatory framework to electricity companies. Quantitatively, the ratings could be downgraded if the interest coverage remains below 2.5x, and the CFO pre-WC-to-Debt falls below 20%, on a sustainable basis. A downgrade of Brazil's sovereign rating could exert downward pressure on Escelsa's rating.

Key Indicators

Exhibit 2

KEY INDICATORS [1]

Espirito Santo Centrais Eletricas - ESCELSA

	12/31/2016	12/31/2015	12/31/2014	12/31/2013	12/31/2012
CFO pre-WC + Interest / Interest	3.3x	3.3x	5.1x	5.8x	5.2x
CFO pre-WC / Debt	33.0%	36.7%	48.0%	50.3%	38.7%
CFO pre-WC – Dividends / Debt	20.4%	36.7%	44.2%	45.0%	23.0%
Debt / Capitalization	48.3%	46.7%	49.7%	51.1%	55.4%

[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™

Detailed Rating Considerations

STRONG CREDIT METRICS DESPITE LOW CONSUMPTION AND CUSTOMER MIGRATION TO FREE MARKET

Over the last two years, Escelsa faced a challenging operating environment, as per Brazil's severe drought season in 2014-15 that caused a significant increase in energy prices and negatively affected the company's profitability. Since mid-2015, the country's economic recession dragged electricity consumption and migration of large customers to the free market left the company with over-contracted energy volumes, which reached 106.8% in FYE2016, up from 96.9% in 2015. These energy surpluses above 105% were sold

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in the free market at relatively lower spot prices (average of BRL120 in 2016 vs BRL290 in 2015), contributing to some deterioration in operating margin.

As a result, the company's credit metrics deteriorated, as indicated by a cash from operations before changes in working capital (CFO pre-WC) to total debt ratio of 33% and an interest coverage ratio of 3.3x for 2016; down from 48% and 5.1x, respectively, on December 31, 2014. Despite the deterioration, Escelsa's credit metrics have weakened less than previously estimated.

EVOLVING REGULATORY ENVIRONMENT

Escelsa has received timely regulatory tariff adjustments that helped mitigate the impact of high energy costs and of the economic recession. In February 2015, ANEEL, Brazil regulator approved an extraordinary tariff adjustment for Escelsa of 26.8%, which helped reduce the negative effects of higher energy costs. More recently, in August 2016, the regulator completed the seventh periodic tariff cycle for Escelsa, which brought an increase of 35% of its Regulatory EBITDA, as per the authorization to earn return on a Net Regulatory Asset Base (RAB) of BRL 2.0 billion.

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. Notwithstanding those supportive regulatory decisions, we consider the electricity distribution sector is not immune to political intervention, as was evidenced in recent years.

LARGER CAPITAL EXPENDITURES AHEAD CONSTRAINT LEVERAGE IMPROVEMENT

The company's capacity to meet the regulatory EBITDA indicated by ANEEL, depend 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 from 2017 through 2019. Escelsa's energy losses reached 13.88% in 2016 and are above the 11.45% regulatory target.

In our base case scenario, we consider capital expenditures in the range of BRL200 million to BRL250 million per year through 2019. 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 45% -52% range.

In 2016, the EDB group has been awarded a concession for a 113-kilometer transmission line and a substation in the state of Espírito Santo, which will require approximately BRL116 million investments through 2019. This new transmission line will contribute to increase power availability and system reliability in the state, which will also benefit Escelsa's distribution business. These transmission developments will be carried out through a separate company and the financing for those investments will be non-recourse to the Escelsa.

Liquidity Analysis

Escelsa reported a cash position of BRL238 million as of December 31, 2016, which covers BRL163 million of debt maturities in 2017. Despite the excess cash cushion, we anticipate a negative free cash flow generation in the range of BRL100 million to BRL200 million over the next 12 to 18 months, primarily as result of higher-than-historical capital expenditures to prevent energy losses and upgrade the network.

We expect improvement in Escelsa's liquidity profile following the upcoming debt refinancing transaction (5th debenture issuance), as it will further lengthen the company's amortization schedule. 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 review cycle starting in August 2019.

Like other Brazilian companies, Escelsa 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.

Escelsa has a track record of high dividend distribution supported by its resilient cash flow generation that has reduced during critical periods, such as in 2014-15. Moody's consider that the company will continue to distribute dividends while its cash flow generation remains robust, but will retain cash to preserve its liquidity in case of need.

Profile

Escelsa, is an electricity distribution utility fully controlled by EDP - Energias do Brasil, S.A. (Ba2 stable), a diversified utility group that is in turn controlled by EDP - Energias de Portugal, S.A. (Baa3 stable). Escelsa serves around 1.5 million clients in 70 municipalities of the state of Espírito Santo, which represents approximately 90% of the state. In 2016, Escelsa reported net revenues of BRL2.5 billion, which does not include construction revenues of BRL234 million, on sales of 10,567 GWh, representing approximately 2% of the electricity consumed in Brazil's integrated system.

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 Escelsa's current rating.

Exhibit 3

Rating Factors

Espirito Santo Centrais Eletricas - ESCELSA

Regulated Electric and Gas Utilities Industry Grid [1][2]	Current FY 12/31/2016		Moody's 12-18 Month Forward View As of 3/6/2017 [3]	
	Measure	Score	Measure	Score
Factor 1 : Regulatory Framework (25%)				
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	Ba	Ba	Ba	Ba
b) Generation and Fuel Diversity	N/A	N/A	N/A	N/A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.8x	Baa	3x - 3.7x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	39.3%	Aa	22% - 28%	A
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	33.8%	Aa	15% - 20%	A
d) Debt / Capitalization (3 Year Avg)	48.2%	Baa	45% - 52%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa3		Baa3
HoldCo Structural Subordination Notching	0	0	0	0
a) Indicated Rating from Grid		Baa3		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 12/31/2016; [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
ESPIRITO SANTO CENTRAIS ELETRICAS - ESCELSA	
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

Recent developments

On March 17, 2017 Moody's changed the outlook of Escelsa to stable from negative. The stabilization of Escelsa outlook follows the stabilization of Brazil's (Ba2, stable) outlook, given the high exposure and close linkages between Escelsa and Brazil's macroeconomic environment and credit quality.

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REPORT NUMBER 1064448