

### Research Update:

## Global And National Scale Ratings On Espirito Santo Centrais Eletricas Are Raised; Outlook Stable

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## Research Update:

# Global And National Scale Ratings On Espirito Santo Centrais Eletricas Are Raised; Outlook Stable

## Overview

- Brazilian electric utility Escelsa posted strong cash generation and improved credit metrics in 2010, following higher energy sales, a positive tariff reset, and efficiency improvements.
- We have raised the ratings on Escelsa, to 'BB+' from 'BB' on the global scale and to 'brAA+' from 'brAA' on the Brazilian National Scale.
- The outlook on the corporate credit ratings is stable, reflecting our expectation that the company will maintain steady financial metrics by managing its existing debt and capital spending needs, while distributing dividends to its holding company.

## Rating Action

On May 3, 2011, Standard & Poor's Ratings Services raised its global scale ratings on Brazilian electric utility Espirito Santo Centrais Eletricas S.A. (Escelsa) to 'BB+' from 'BB' and its Brazilian national scale rating on the company to 'brAA+' from 'brAA'. The outlook on the corporate credit rating on both scales is stable. At the same time, we revised affiliate company Bandeirante Energia S.A.'s national scale outlook to positive from stable.

## Rationale

The upgrade reflects Escelsa's improved credit metrics in 2010, coupled with stronger operating indicators and lower losses. Also, it significantly improved cash generation in the year, which helped it report stronger credit metrics. We project capital spending to be moderate and free operating cash flow (FOCF) to remain positive in the next few years, allowing the company to keep distributing dividends and sustaining stable credit metrics during that time.

Escelsa's fair business profile reflects the benefits from an exclusive concession to distribute electricity in most part of the state of Espírito Santo. The state consists of 70 municipalities with a balanced customer base among residential, commercial, and industrial customers (although there are relevant free clients in the region). Electricity losses have been declining and are now close to the regulator's target standards (although still somewhat high at 14% in 2010) and operating statistics (measured by outage frequency and outage duration) have improved. The Brazilian electric sector's regulatory framework has shown a positive track record during the past seven years.

However, there is some regulatory uncertainty in the intermediate term because the regulator will reset tariffs again in August 2013. Energias de Portugal, S.A. (EDP: BBB/Negative/A-2) ultimately controls Escelsa, which we view as a positive given its increasing integration and some operating synergies with the rest of EDP's assets in Brazil.

During 2010, demand in Escelsa's concession area increased in all segments, especially industrial, fully recovering from its weak 2009 levels. Indeed, overall demand increased 5.3% in 2010, while industrial clients' demand increased 9.3%. Wheeling fees, collected from export-oriented free clients, also improved in 2010. The combination of this volume increase with a positive 7.19% tariff reset in August 2010 (mainly because of a positive review of its regulatory asset base), resulted in an 11% revenue increase, while EBITDA margin increased to 22.3% in 2010 from 21.8% in 2009. Escelsa's profitability has been traditionally quite stable.

We assess Escelsa's financial risk profile as significant. The company's financial performance is improving, with strong results in 2010 reflecting increased demand and the partial effect of its August 2010 tariff reset (which will be fully captured in 2011), leading to stronger cash generation with adequate cash flow protection measures. There is some refinancing risk associated with its large debenture amortization schedule until 2014. Capital spending will be moderate in the next few years, as Escelsa has completed its regulatory investments in its "Lights For All" program, but they are still much needed for it to keep improving operating indicators. We expect credit metrics for Escelsa to remain quite stable in the next three years. We also expect it to adequately manage its capital structure and liquidity, preserving cash holdings to manage its debenture amortization and still distribute significant dividends to its shareholders. We expect total debt to EBITDA and funds from operations (FFO) to total debt to be around 2.5x and above 40%, respectively, in the next few years (2.6x and 45% in December 2010, respectively).

### **Liquidity**

Escelsa's liquidity is adequate. As of December 2010, Escelsa had short-term debt of Brazilian real (R\$) 138 million and R\$156 million in cash holdings. Short-term debt basically consists of the current portion of long-term debts. With moderate capital spending, we project Escelsa to report positive FOCF of about R\$100 million in 2011, and maintain that improvement from then on in our base case scenario. As such, we believe Escelsa will manage debt amortization in the next few years with internal cash generation and cash reserves. It might finance capital spending with long-term debt, such as with loans from Brazil Development Bank, as it did in 2010, but credit metrics will likely remain stable as existing debt is amortized. Although we project Escelsa to keep distributing sizable amounts of dividends in the next few years, we believe they could decrease if a liquidity crunch occurs. Escelsa has financial covenants associated with its debentures issuance. We project Escelsa to sustain comfortable headroom on its debt covenants.

## Outlook

The stable outlook reflects our expectation that Escelsa will maintain steady financial metrics by managing its existing debt and capital spending needs, while distributing dividends to its holding company. We expect Escelsa to post FFO to total debt above 40%, total debt to EBITDA around 2.5x, and total debt to total capitalization of around 50%, even considering potentially higher dividend distribution. A positive rating action could come from further improvement in Escelsa's operating indicators, coupled with consistently stronger-than-expected financial metric, such as total debt to EBITDA near 1.5x and FFO to total debt above 50%. We could take a negative rating action if Escelsa fails to maintain adequate cash generation to meet its debenture amortization or if there is a steep decline in electricity consumption in its concession area with a strong impact on its credit metrics, leading to ratios such as FFO to total debt below 30% and total debt to EBITDA above 3.0x.

## Related Criteria And Research

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Standard & Poor's Revises Its Approach To Rating Speculative-Grade Credits , May 13, 2008

## Ratings List

### Ratings Raised

Espirito Santo Centrais Eletricas S.A.

	To	From
Corporate Credit Rating		
Global Scale	BB+/Stable/--	BB/Stable/--
National Scale	brAA+/Stable/--	brAA/Stable/--
Senior Unsecured	brAA+	brAA

### Outlook Revised

Bandeirante Energia S.A.

Corporate Credit Rating

National Scale	brAA+/Positive/--	brAA+/Stable/--
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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at [www.globalcreditportal.com](http://www.globalcreditportal.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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