

CREDIT OPINION

25 April 2018

Update

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RATINGS

EDP Espirito Santo Distribuicao de Energia SA

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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EDP Espirito Santo Distribuicao de Energia SA

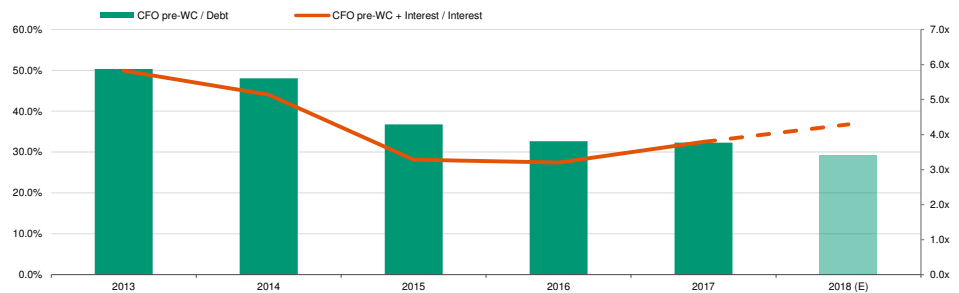
Update Following Outlook Change to Stable

Summary Rating Rationale

EDP Espirito Santo Distribuição de Energia S.A. (EDP - Espirito Santo)'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 July 2025, (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 32% and Interest Coverage Ratio of 3.8x in 2017, and (iii) an evolving regulatory environment with recent evidence 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 - Espirito Santo's credit ratings are: (i) the expected leverage increase to support capital investments to upgrade the network and prevent losses before the next tariff review cycle in August 2019 and ii) the track record of high dividend distributions to the parent. The rating remains somewhat constrained by [Brazil's Government rating](#) (Ba2, stable), given the intrinsic links between the company and the credit quality of sovereign due to its regional customer base.

Exhibit 1
Resilient Credit Metrics to Remain



Source: Moody's Financial Metrics™, Moody's estimates

Credit Strengths

- » Stable operating cash generation expected for 2018 and 2019
- » 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 - Espirito Santo 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

A rating upgrade would depend on sustained improvement in the relevant credit metrics, the liquidity profile or a material improvement in the regulatory frameworks under which EDP - Espirito Santo operates. A rating upgrade would be considered if Brazil's government bond rating is upgraded. 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 improves close to 55%, and
- » The interest coverage approaches 5.5x on a sustainable basis.

Factors that Could Lead to a Downgrade

Downward rating pressure could come with a deterioration in EDP - Espirito Santo's liquidity position, resulting from weaker than anticipated growth in its concession area, or from a larger than anticipated dividend distribution. A change in the perceived level of support from the electricity regulatory framework or a downgrade of Brazil's government bond rating could exert downward pressure on EDP - Espirito Santo's ratings. 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 below 3.0x for a prolonged period.

Key Indicators

Exhibit 2

KEY INDICATORS [1]

EDP - Espirito Santo 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	3.8x	3.2x	3.3x	5.1x	5.8x
CFO pre-WC / Debt	32.3%	32.7%	36.7%	48.0%	50.3%
CFO pre-WC – Dividends / Debt	15.3%	20.1%	36.7%	44.2%	45.0%
Debt / Capitalization	58.7%	48.3%	46.7%	49.7%	51.1%

[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™

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Corporate Profile

EDP - Espirito Santo, is an electricity distribution utility fully controlled by EDP - Energias do Brasil, S.A. (EDB; Ba2, stable), a diversified utility group that is in turn controlled by [EDP - Energias de Portugal, S.A.](#) (Baa3, stable). EDP - Espirito Santo serves around 1.5 million clients in 70 municipalities of the state of Espirito Santo, which represents approximately 90% of the state. In December 31, 2017, EDP - Espirito Santo reported net revenues of BRL2.6 billion, which does not include construction revenues of BRL313 million, on sales of 10,183 GWh, representing approximately 2% 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 in EDP - Espirito Santo's service area continued to deteriorate as evidenced by a 3.6% decrease in sales volume as compared to 2016. The reduction reflected primarily a lower demand from captive industrial consumers, despite the gradual economic recovery observed in the country since the recession 2016 and 2015 levels. As a result, the company's over contracted position in energy volumes reached 108.6%, up from 106.8% in 2016.

The energy surpluses above 105% are sold in the free market, thus increasing the company's exposure to margin losses from trades at lower prices. Nevertheless, the relatively higher spot prices during 2017, that reached BRL318 per MWh on average as compared to BRL122 per MWh in 2016, contributed to an operating non recurring gain for EDP Escelsa of approximately BRL58.5 million last year.

As a result, the company's credit metrics remained relatively stable in 2017, as indicated by a CFO pre-WC to total debt ratio of 32% and an interest coverage ratio of 3.8x for 2017; from 33% and 3.2x, respectively, in 2016. On the other hand, EDP - Espirito Santo posted lower free cash flow of BRL-198 million in 2017 vs. BRL1 million in 2016 (as per Moody's adjustments), mostly driven by the higher investment and dividends. In 2018, we anticipate similar cash flow 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 - Espirito Santo has received timely regulatory tariff adjustments that helped to mitigate the impact of high energy costs and of the economic recession. For example, in February 2015, ANEEL, Brazil regulator approved an extraordinary tariff adjustment for EDP - Espirito Santo 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 EDP - Espirito Santo, 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.

For EDP - Espirito Santo next review cycle scheduled in August 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 - Espirito Santo'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 continued large capital expenditures in 2018 and 2019. EDP - Espirito Santo's energy losses improved to 11.94% in 2017, down from 13.50% in 2016, and closer to the 11.45% regulatory target for that year. In our base case scenario, we consider capital expenditures in the range of BRL260 million to BRL330 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.

In 2016, the EDB group was 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 EDP - Espírito Santo'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 EDP - Espírito Santo.

EDP - Espírito Santo 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 considers 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.

Liquidity Analysis

As of December 30, 2017, EDP - Espírito Santo reported a cash position of BRL185 million, which was not enough to cover BRL216 million of short term debt maturities in 2018. Like other Brazilian companies, EDP - Espírito Santo does not have committed banking facilities to face any unexpected cash disbursements. Nevertheless, we deem the company's liquidity as manageable given the track record of resilient access to capital markets and intrinsic benefits derived from being part of EDB group.

During 2017, the company issued the 5th and 6th debentures, amounting BRL410 million, of which BRL100 million (second series of the 6th debentures issuance) was disbursed in January 2018.

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.

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 Ba1, which is one notch above EDP - Espírito Santo's current rating.

Exhibit 3

Rating Factors

EDP - Espirito Santo Distribuição de Energia S.A. (EDP - Espirito Santo)

Regulated Electric and Gas Utilities Industry Grid [1][2]	Current FY 12/31/2017		Moody's 12-18 Month Forward View As of 4/20/2018 [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
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.4x	Baa	3.5x - 4.5x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	33.7%	Aa	23% - 30%	A
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	23.2%	A	5% - 10%	Ba
d) Debt / Capitalization (3 Year Avg)	51.3%	Baa	50% - 60%	Ba
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa3		Ba1
HoldCo Structural Subordination Notching	0	0	0	0
a) Indicated Rating from Grid		Baa3		Ba1
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 5

Category	Moody's Rating
EDP ESPIRITO SANTO DISTRIBUICAO DE ENERGIA SA	
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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