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CREDIT OPINION
5 April 2019

Update

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EDP Espirito Santo Distribuicao de Energia SA

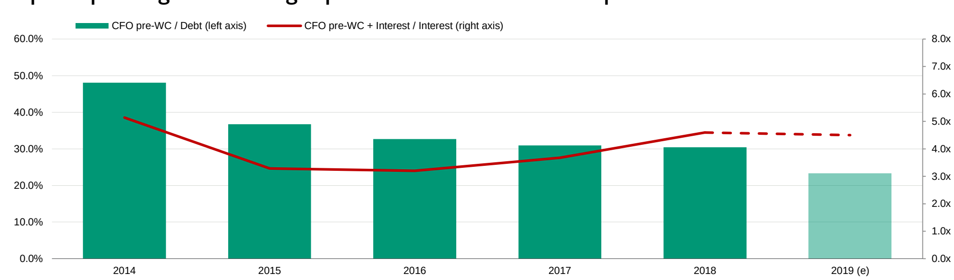
Update to credit analysis

Summary Rating Rationale

The credit profile of EDP Espirito Santo Distribuição de Energia S.A. (EDP - Espirito Santo, Ba2/Aa1.br stable) reflects (1) the relatively stable and predictable nature of its cash flow derived from a distribution concession that is valid through July 2025, (2) the company's strong credit metrics for the rating category, illustrated by the ratio of cash flow from operations before changes in working capital (CFO pre-WC) to debt of 30% and Interest Coverage Ratio of 4.6x in 2018, and (3) an evolving regulatory environment with a track record of support aimed at providing timely relief to electricity distribution companies facing financial risk. Continued access to the local capital markets and the implicit support from its parent holding company EDP - Energias do Brasil S.A. (EDB; Ba2/Aa2.br stable) are also important rating considerations.

Constraining EDP - Espirito Santo's credit ratings are (1) the company's increasing leverage to support capital investments to upgrade the network and prevent losses before the next tariff review cycle in August 2019, (2) the expectation of high dividend distributions to the parent, and (3) the exposure to high working capital needs according to hydrological conditions. 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
Capital spending and working capital needs will constrain improvement in credit metrics in 2019



Source: Moody's Investors Service

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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Credit Strengths

» Economic recovery supporting cash flow generation over the next 12-18 months

» Strong credit metrics for the rating category, despite leverage increase

» Evolving regulatory framework with a track record of consistent decisions and timely support to the utility

Credit Challenges

» Exposure to volatile working capital needs amid unfavorable hydrological conditions

» Expectation of high dividend payout to the parent, EDB

» Investment requirements on grid expansion and upgrades expected to remain high beyond the current review cycle

Rating Outlook

The stable outlook on EDP - Espirito Santo reflects our expectation that the company's credit metrics will remain well positioned for the rating category, although relatively lower than the historical levels. The stable outlook on EDP - Espirito Santo is also in line with that on Brazil's sovereign rating.

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 is upgraded. A rating upgrade or a change in outlook to positive would also depend on a sustained improvement in the relevant credit metrics and its liquidity profile, or a material improvement in the regulatory frameworks under which EDP - Espirito Santo 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 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 arise if there is a deterioration in EDP - Espirito Santo's liquidity position, resulting from weaker-than-expected 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 also exert downward pressure on EDP - Espirito Santo's rating. Quantitatively, the ratings could be downgraded if we see a sustainable deterioration in its credit metrics, so that:

» The CFO pre-WC-to-Debt falls below 25%, or

» The interest coverage stays below 4.0x.

Key Indicators

Exhibit 2
KEY INDICATORS [1]
EDP - Espirito Santo Distribuição de Energia S.A.

	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
CFO pre-WC + Interest / Interest	5.1x	3.3x	3.2x	3.7x	4.6x
CFO pre-WC / Debt	48.0%	36.7%	32.7%	30.9%	30.4%
CFO pre-WC – Dividends / Debt	44.2%	36.7%	20.1%	13.9%	22.9%
Debt / Capitalization	49.7%	46.7%	48.3%	58.7%	58.9%

[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™

Profile

EDP - Espirito Santo, headquartered in Vitoria, in is an electricity distribution utility fully controlled by EDB, 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 Espírito Santo, which represents approximately 90% of the state. In 2018, EDP - Espirito Santo reported net revenues of BRL3.0 billion (not including construction revenue of BRL335 million, as per Moody's adjustments) and net income of BRL170 million, with 10,158 gigawatt hours of distributed energy volumes, representing around 2.2% of the electricity consumed in Brazil's integrated system.

Detailed Rating Considerations

Track record of resilient credit metrics despite economic volatility

EDP - Espirito Santo exhibits a solid credit metric profile, supported by its regulated business in a developed service region that experienced some challenging economic conditions in recent years but has been recently recovering.

In 2018, total energy distribution reached 10,158 gigawatt hours, a 3.1% growth from 2017, driven mostly by higher electricity demand from consumers in the free market. The demand from regulated customers increased more than we expected, with a 2.0% growth from 2017 as compared to 1.6% of the national average. On the other hand, EDP - Espirito Santo continued to register an over contracted position in energy volumes of 107.09%, which is above the regulatory threshold of 105% for cost recovery allowances with a negative impact to the operating margin.

In 2018, EDP - Espirito Santo experienced increase in non-manageable costs of around 19%, as a result of increase in energy purchase costs in the spot market and the devaluation of local currency with an impact on dollar-denominated power purchase agreements with Itaipu Binacional, as well as higher sector charges. Recurring manageable costs, including general and administrative expenses and third-party services, also increased about 5% from 2017. The negative impact of higher operating costs was partially compensated by a 15.9% tariff increase granted by the regulator in August 2018, as part of the company's annual tariff review process, leading to relatively stable operating margin for the company.

Despite a moderate increase in leverage to support working capital management, EDP - Espirito Santo's ratio of CFO pre-WC to debt remained around 30% in 2018, while the interest coverage ratio increased to 4.6x from 3.7x in 2017 supported by lower interest costs. These metrics remain well positioned for the Ba2 rating category.

We view regulated electric utilities as well positioned to benefit from the gradual industrial production recovery and progressive decline in unemployment in the country. We forecast that regulated electricity consumption in Brazil will resume growth to around 2% in the next 12-18 months, in line with the GDP growth. In this scenario, we expect EDP - Espirito Santo's ratio of CFO pre-WC to debt to remain in the 25%-30% range, while its interest coverage would remain around 4.5x - 5.5x. An improvement in leverage is currently constrained by Moody's expectation that the company's capital spending will remain high along with large dividend distributions to the parent.

Regulatory environment evolving positively

The National Agency of Electric Power (ANEEL) has consistently applied tariff increases in line with its methodology, and has demonstrated that it is closely monitoring the performance and working capital needs of distribution companies. Recent regulatory decisions aimed at mitigating the impact of high energy costs and 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. We expect the sector's benign regulatory framework to continue over the next 12-18 months.

During the most recent economic recession, EDP - Espirito Santo received timely regulatory tariff adjustments that helped mitigate the impact of high energy costs. In February 2015, ANEEL approved an extraordinary tariff adjustment of 26.8% for EDP - Espirito Santo, which helped reduce the negative effects of higher energy costs because of the severe drought season. In August 2016, the regulator also 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.

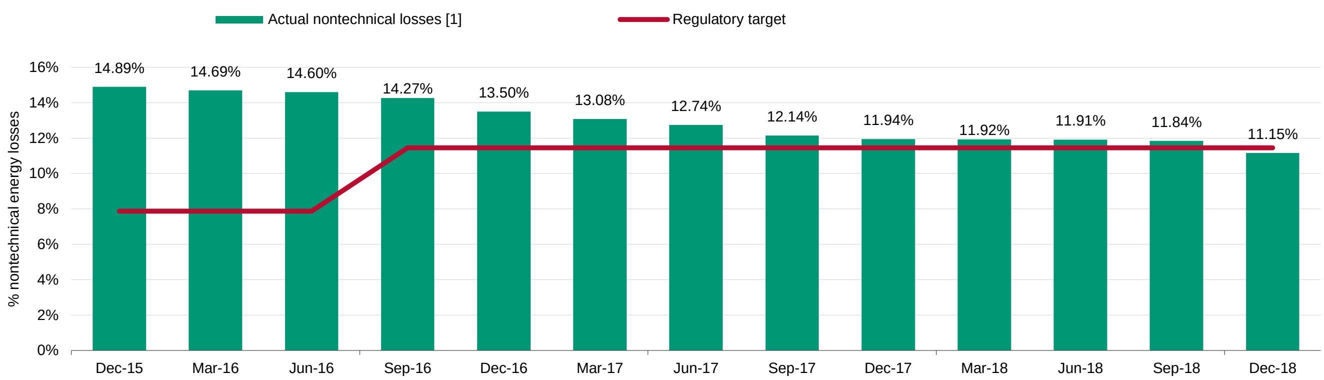
For the next review cycle scheduled in August 2019, ANEEL has already indicated no change in the weighted average cost of capital (WACC) used to calculate tariff increase, maintaining this rate at 8.09%, which will contribute to lower volatility in the company's future cash flow.

Large capital expenditures to achieve regulatory targets

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. The company's nontechnical energy losses at the low-tension grid (mostly related to illegal electricity connections by consumers) have seen a substantial decrease, reaching 11.15% in December 2018, down from 14.89% in December 2015. This reduction reflects the company's larger capital spending on grid upgrades, connection of new clients and equipment replacement for remote monitoring in the range of BRL230 million-BRL330 million per year since 2016.

Exhibit 3

Nontechnical losses have been consistently decreasing due to higher investments



[1] Last 12 months average
Source:EDP - Espirito Santo

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 began operations in December 2018, 20 months before the regulatory schedule. This new transmission line will contribute to increase power availability and system reliability in the state, which will also benefit EDP - Espirito Santo's distribution business. The transmission investments have been carried out through a separate company and the financing for those investments is non-recourse to the EDP - Espirito Santo.

The ratings base case takes into consideration capital spending in the range of BRL340 million-BRL380 million per year through the next review cycle until 2022, to support further reduction in energy losses and sustain improvement in other qualitative targets. We assume this will be financed with a combination of internal and external cash generation so that the company's ratio of debt to total capitalization remains in the 60%-65% range.

Low carbon transition risk

EDP - Espirito Santo has low carbon transition risk within the utility sector because it is an electricity distribution utility with no generation ownership. All energy costs associated with power procurement, including those that are generated from carbon sources, are fully passed through to the customers with an effective cost recovery mechanism. Although transmission and distribution companies generally have low carbon transition risk, a sharp growth in rooftop solar and energy efficiency among customers in EDP - Espirito Santo's service territory could eventually result in a decline in the company's volumes. Risks associated with this scenario are mostly centered on the potential for stranded assets and affordability concerns in light of tariff increases that may be needed to compensate for the grid investments. However, we currently do not see broader national energy policies or the influence of regional market forces to have a material impact on the company's credit profile over the next three to five years.

Liquidity Analysis

EDP - Espirito Santo reported a cash position of BRL69 million as of December 31, 2018, with BRL199 million of debt coming due 2019, comprising the maturity of its 3rd debentures issuance and biannual and annual amortization of its 5th and 6th debentures issuances, respectively. The low cash buffer to short-term debt is mainly a result of the high regulatory liability payments in the last year.

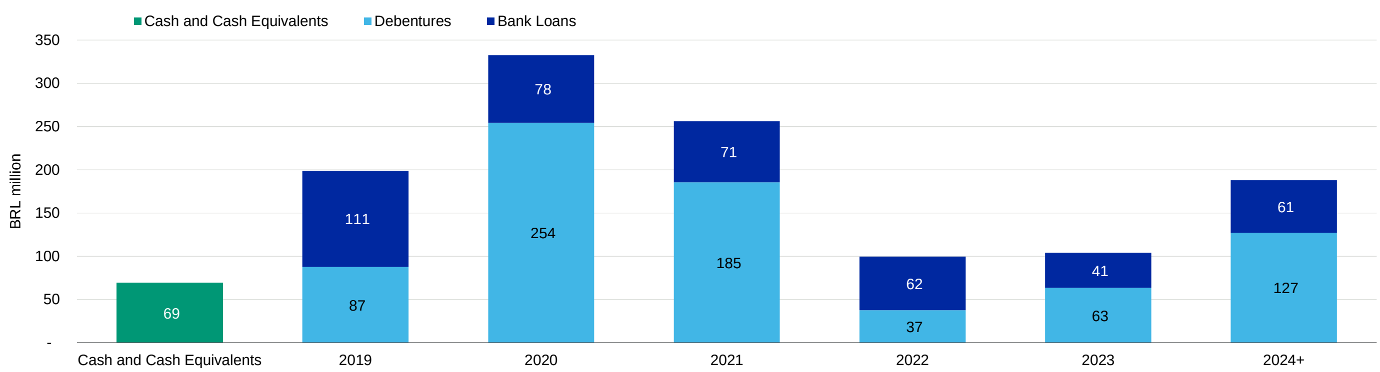
For this year, we expect the combination of favorable regulatory decisions, coupled with a gradual improvement in Brazil's macroeconomic fundamentals, to further help the company improve its liquidity buffer and sustain adequate credit metrics through the next tariff review cycle starting in September 2019. We expect higher operating cash flow generation after capital spending in the range of BRL50 million - BRL100 million in 2019.

EDP - Espirito Santo has a track record of high dividend distribution supported by its resilient cash flow generation. We assume the company will continue to distribute most of its net earnings to its parent, but with the option to retain distributions to preserve an adequate cash position in case of enhanced market volatility or sudden cash needs.

Like other Brazilian companies, EDP - Espirito Santo does not have committed banking facilities to face any unexpected cash disbursements. Although the company will face relatively high refinancing needs over the next 12 to 24 months, we expect its proven execution track record and sound access to the local bank and capital markets as part of the EDB group to ensure the company's ability to refinance its short-term obligations.

Exhibit 4

High refinancing needs in the short term mitigated by sound access to capital markets



Source: EDP - Espirito Santo

Rating Methodology and Scorecard Factors

The outcome of our 12-18-month forward-looking view of the Regulated Electric and Gas Utilities methodology grid is Baa3, which is two notches above EDP - Espirito Santo's current rating, reflecting its strong credit metrics and market position.

Exhibit 5
Rating Factors
EDP - Espirito Santo Distribuição de Energia S.A.

Regulated Electric and Gas Utilities Industry Grid [1][2]	Current FY 12/31/2018		Moody's 12-18 Month Forward View As of 4/01/2019 [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	Ba	Ba	Ba	Ba
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.8x	Baa	4.5x - 5.5x	A
b) CFO pre-WC / Debt (3 Year Avg)	31.2%	Aa	23.% - 29%	A
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	19.1%	A	13% - 17%	Baa
d) Debt / Capitalization (3 Year Avg)	55.6%	Ba	60% - 65%	Ba
Rating:				
Grid-Indicated Outcome Before Notching Adjustment		Baa3		Baa3
HoldCo Structural Subordination Notching				0
a) Indicated Rating from Grid				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 12/31/2018; [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 6

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

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