MOODY'S
INVESTORS SERVICE

Credit Opinion: Lajeado Energia S.A.

Global Credit Research - 18 Dec 2015

Sao Paulo, Brazil

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	Ba1
Senior Unsecured -Dom Curr	Ba1
NSR Senior Unsecured	Aa2.br
NSR LT Issuer Rating	Aa2.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	Negative
Corporate Family Rating -Dom Curr	Ba2
Senior Unsecured -Dom Curr	Ba2
NSR Corporate Family Rating	Aa3.br
NSR Senior Unsecured	Aa3.br

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Key Indicators

[1]**Lajeado Energia S.A.**

	6/30/2015(L)	12/31/2014	12/31/2013	12/31/2012	12/31/2011
(CFO Pre-W/C + Interest) / Interest	**3.0x**	**3.1x**	**9.5x**	**16.0x**	**15.9x**
(CFO Pre-W/C) / Net Debt	**35.5%**	**35.2%**	**53.9%**	**185.1%**	**120.2%**
RCF / Net Debt	**10.2%**	**29.8%**	**11.0%**	**78.2%**	**40.2%**
(CFO Pre-W/C) / Debt	**24.9%**	**27.1%**	**48.6%**	**124.9%**	**116.0%**
RCF / Debt	**7.2%**	**22.9%**	**9.9%**	**52.7%**	**38.8%**

[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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Historically strong credit Metrics

Relatively stable cash flow supported by long-term supply contracts

Recent poor financial performance from high exposure to the spot market over the past two years

Adherence to the new legislation on the renegotiation of hydrological risk

Corporate Profile

EDP Energias do Brasil (EDB; Ba2, negative) is Lajeado Energia S.A's (Lajeado) major shareholder with 55.9% of its capital. The other two shareholders are ELETROBRAS (Ba2, URD) with 40.1% of its capital and the state government of Tocantins (not rated) which holds the remaining 4.1%. Lajeado holds 72.27% of the concession to operate the hydroelectric power plant Luis Eduardo Magalhães (UHE Lajeado) located in the State of Tocantins, which expires in January 2033. UHE Lajeado operates five turbines with a total installed capacity of 902.5 MW and assured energy of 526 MW. The other owners of the UHE Lajeado facility, which Moody's does not rate, are CEB Lajeado S.A. (19.80%), Paulista Lajeado Energia S.A. (6.93%) and Investco (1.00%).

These companies along with Lajeado are the shareholders of Investco S/A (Investco; not rated), which is a special purpose company created to finance and operate UHE Lajeado facility. Lajeado holds 73% of Investco's voting capital and 62.4% of its total capital.

Investco has signed long-term leasing contracts, represented by the UHE Lajeado assets with its shareholders in proportion to their participation in the concession. As a result, Investco's shareholders have made regular tailor-made lease payments to Investco so that the latter can meet its cash needs, which includes all operating, and financial expenses.

Investco has two sources of revenues: (i) lease payments from its shareholders for use of the power produced by UHE Lajeado plant; and, (ii) the equivalent of 1% of the energy sales generated from its participation in the UHE Lajeado.

Recent Events

On December 8, 2015, the federal government published law #13,203 on the renegotiation of the hydrological risk.

On December 16, 2014, Lajeado announced that it had obtained a waiver from the debenture holders of the 6-year amortizing BRL 450 million debenture, which agreed not to accelerate the maturity of this debenture because of the likely breaching of the maximum gross debt over EBITDA financial covenant ratio of 3.5x. to be calculated in the first quarter of 2015 based on the company's financial statements as of December 31, 2014.

The debenture holders granted Lajeado the waiver and required the payment of a 0.9% fee over the debenture principal amount to be paid within the end of December. The waiver of the maximum debt financial covenant is valid through the end of December 2015.

On December 15, 2014, Moody's America Latina Ltda (Moody's) downgraded Lajeado Energia S.A. (Lajeado)'s issuer ratings to Ba1/Aa2.br from Baa3/Aa1.br. Moody has also downgraded to Ba1/Aa2.br from Baa3/Aa1.br the ratings of Lajeado's BRL 450 million senior unsecured amortizing debentures with a final maturity in October 2019. In addition, the outlook of all ratings was changed to negative from stable.

On September 27, 2013, Moody has assigned a Baa3 issuer rating on the global scale and an Aa1.br issuer rating on the Brazilian national scale to Lajeado. At the same time, Moody's assigned a Baa3 rating on the global scale and a Aa1.br rating to the 6-year amortizing unsecured senior debentures of BRL 450 million that Lajeado issued in October 2013 in the local market. The outlook was stable for all ratings. This was the first time that Moody's had assigned a rating to Lajeado.

In August 2013, Lajeado executed a capital split of BRL 450 million that had been approved by the regulator ANEEL. Lajeado funded the capital split through the issuance of BRL 450 million promissory notes, which were taken out by the subsequent debenture issuance.

SUMMARY RATING RATIONALE

Despite the historically strong credit metrics and the long-term purchase power agreements (PPAs) mostly signed with distribution companies the Ba1/Aa2.br issuer ratings reflect Lajeado's weaker than expected financial performance in 2014 and 2015 in light of its high exposure to the spot market. The fact that Lajeado holds 73% of a concession that expires in 2033 to operate the UHE Lajeado hydro plant further supports the ratings.

DETAILED RATING CONSIDERATIONS

HISTORICALLY STRONG CREDIT METRICS

Lajeado has historically posted strong consolidated credit metrics characterized by very low leverage as evidenced by the average consolidated Debt/EBITDA ratio of just 1.8x from 2012 through June 2015. This has largely resulted from high operating margins that have been supported by attractive energy tariffs from long-term energy supply contracts mostly signed with distribution companies.

Likewise, Lajeado's cash flow has been very strong not just because of high operating margins but also because of historically low annual capital expenditures of just BRL 11 million in the same period, which compares with the company's previous annual average FFO of BRL 221million resulting in a FFO over debt ratio of 43.6% in the same period. During this period, the annual payment of dividends averaged BRL 128.5 million, which has been the company's main cash drain during this period leading to a more modest RCF (Retained cash flow) over debt ratio of 25.33%.

The execution of the BRL 450 million capital split funded by the borrowing of long-term debentures in the same amount at the end of 2013 was the main factor behind the increase in the company's leverage as measured by Debt over EBITDA ratio of 1.6x as of December 31, 2013. As a result of lower operating profit registered in the second half of 2014 and first half of 2015, the debt over EBITDA ratio deteriorated to 2.8X in the last twelve months ended June 30, 2015.

Lajeado posted a weaker financial performance in the first half of 2015 as measured by consolidated EBITDA of BRL 118 million or 42.1% of net sales down from BRL 167.5 million or 63.0% of net sales generated for the same period in 2014 largely explained by increased costs with the acquisition of energy on the spot market.

The Generation Scaling Factor (GSF) averaged 0.909 in 2014, forcing the company to acquire around 9% of its physical energy on the spot market whose price averaged BRL 685 per megawatt hour. In the first half of 2015, the combination of lower energy consumption along with higher dispatch of thermo power to preserve water in the Brazilian hydro water reservoirs resulted in a lower GSF of 0.80, forcing Lajeado to acquire around 20% of its physical energy on the spot market whose price averaged BRL 380 per megawatt hour. As a result, Lajeado incurred BRL 126.6 million of energy acquisition costs in the first half of 2015 up from BRL 48.9 million in the same period of 2014.

CREDIT METRICS TO IMPROVE IN 2016

Lajeado's credit metrics have been deteriorating in light of the company's high exposure to the spot market since the beginning of 2014 and, more specifically, in the second half of 2014 and first half of 2015.

The exposure to the spot market stems from the fact that the company's physical energy is fully contracted through long-term supply contracts mostly with Brazilian distribution companies and the fact that in light of the current severe drought the National System Operator (ONS) has dispatched more expensive thermal power to the detriment of the production of hydro power. As a result, Lajeado has been forced to acquire energy on the spot market to make up the difference between its reduced energy production and physical energy obligations.

We expect that the company's credit metrics will improve in 2016 given our expectation of a higher GSF at around 0.90 and lower spot prices at around BRL 130 per megawatt hour due primarily to reduced levels of electricity consumption, which has had a favorable impact on reservoir levels. We also expect that the company will adhere to the new law #13,203 on the renegotiation of the hydrological risk in the regulated market and limit potential losses associated with its exposure to the spot market through the payment of a premium.

Management has not decided yet on the level of protection and respective premium, which the company will choose among the 25 alternatives available for those generators operating in the regulated market. It is not clear if the company will accept the conditions of the new law for the unregulated market, as we understand that there are other hedging mechanisms that could offer adequate levels of protection but at a lower cost. As per management information, 61% of its physical energy is in the regulated market and 39% in the unregulated market.

Hydro generators will have until January 15, 2016 to decide if they will accept the terms and conditions of the new law and give up their legal challenges that has resulted in injunctions that have prevented them to pay for the costs arising with their exposure to the spot market under the operational procedures of the MRE.

As per management information, the company has recognized all the energy acquisition costs on the spot market in its profit and loss statements but not all of those costs have been disbursed. We estimate that the amount to be settled is not material and should not exceed BRL 70 million in 2015.

Nevertheless, Lajeado's profitability and cash flow could remain volatile from 2016 through 2018 as a result of a continuation of the drought which has prevailed over the past three years in Brazil in conjunction with the increase in the acquisition of energy on the spot market at high prices because of the lower levels of water in the Brazilian water reservoirs and the higher costs associated with dispatching thermal plants to cover the shortfall in hydro production.

HYDROLOGICAL RISK

The risk of an energy rationing in 2016 is very low. This stems from the combination of low electricity consumption in the Brazilian integrated system, which is estimated to decline by 2% in 2015 and be flat in 2016, increased installed power capacity along with higher water levels in the Brazilian water reservoirs.

Notwithstanding, the levels of the Brazilian hydro water reservoirs are still low when compared to historical levels but materially higher than last year. The level of the water reservoir in the southeastern and mid-western region, which represents 70% of all hydro water Brazilian reservoirs, reached 27% as of November 30, 2015 significantly higher than the 16% level last year which was the lowest level in a decade but considerably lower than the 43.1% average from 2010 through 2013. The second most important water reservoir located in the northeastern region and that represents 18% of all Brazilian hydro water reservoirs, is at very critical level of just 4.5% as of November 30, 2015 down from 13.0 % last year.

In spite of the low water levels in most of the Brazilian hydro water reservoirs coupled with the fact that some power plants have not come on stream as planned by the government over the past three years the Brazilian National System Operator (ONS) has reportedly stated that the risk of energy rationing is not significant in light of the forecasted more favorable level of rain starting this December, which ONS believes will be over 90% of the long-term historical average. ONS indicated that it would keep dispatching thermal power to help restore water in the Brazilian water reservoirs.

We will keep monitoring the water levels of the Brazilian reservoir system along with the dispatch of thermal power and the resulting impact that this will have on the energy spot prices to evaluate how the Brazilian generation companies will be affected.

Liquidity Profile

Like other Brazilian companies, Lajeado does not have committed banking facilities to face any unexpected cash disbursements. In spite of this lack of committed banking facilities, we have deemed the company's liquidity as adequate given the fact that its debt is solely concentrated in the long term.

We understand that Lajeado will adhere to law #13,203 and determine a level of protection among the 25 alternatives available for the energy negotiated in the regulated market, which represents around 61% of the company's energy portfolio. As a result, Lajeado will most likely not breach the existing 3.5x gross debt to EBITDA financial covenant embedded in its BRL 450 million debentures at the level of the holding company because the bulk of the costs associated with its exposure to the spot market will be recognized as an intangible asset rather than as cost of goods sold.

Rating Outlook

The negative outlook reflects the myriad of uncertainties currently confronting the Brazilian electricity sector due to the persistent drought conditions of the last three years, particularly for those hydro generators that are fully contracted and have been forced to secure power on the volatile and expensive spot market to meet their energy obligations under PPAs with distribution companies.

What Could Change the Rating - Up

We do not foresee any upgrade rating action over the medium-term horizon in light of the recent downgrade rating action and the uncertainties currently confronting the electricity sector in Brazil. We would consider stabilizing the rating outlook if the company is able to stem the expected deterioration in its credit metrics and at the same time demonstrate an adequate liquidity position compatible with its current Ba1/Aa2.br rating category.

What Could Change the Rating - Down

We would consider downgrading Lajeado's ratings should the company post a further deterioration in credit metrics, which could occur if the company's exposure to the spot market in 2016 becomes more pronounced than our expectation so that the FFO over net debt ratio goes below 20%. Deterioration in the company's liquidity could also prompt a downgrade rating action.

We will continue to monitor the company's performance as well the evolvement of the implementation of law 13,203 on the renegotiation of the hydrological risk that will have a material impact on how the company will recognize the costs associated with its exposure to the spot market in 2015, which will ultimately determine its ability to avoid breaching the financial covenant embedded in its debentures and prevent debentures holders to accelerate its maturity.

Rating Factors

Lajeado Energia S.A.

Unregulated Utilities and Unregulated Power Companies Industry Grid [1][2]	**Current LTM 6/30/2015**		[3]**Moody's 12-18 Month Forward ViewAs of 12/17/2015**	
Factor 1 : Scale (10%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale (USD Billion)	Caa	Caa	Caa	Caa
Factor 2 : Business Profile (40%)				
a) Market Diversification	Ba	Ba	Ba	Ba
b) Hedging and Integration Impact on Cash Flow Predictability	Baa	Baa	Baa	Baa
c) Market Framework & Positioning	Ba	Ba	Ba	Ba
d) Capital Requirements and Operational Performance	A	A	A	A
e) Business Mix Impact on Cash Flow Predictability		NA		
Factor 3 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg)	3.7x	Ba	4.2x	Ba
b) (CFO Pre-W/C) / Net Debt (3 Year Avg)		NA		
c) RCF / Net Debt (3 Year Avg)		NA		
b) (CFO Pre-W/C) / Debt (3 Year Avg)	33.3%	Baa	49.7%	A
c) RCF / Debt (3 Year Avg)	3.9%	B	5.6%	B
Rating:				
a) Indicated Rating from Grid		Ba1		Ba1
b) Actual Rating Assigned		Ba1		Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 6/30/2015(L); Source: Moody's Financial Metrics [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

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