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Research Update:

Energisa S.A. And Subsidiaries 'BB-' Global And 'brAAA' National Scale Ratings Affirmed; Outlook Remains Stable

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Overview

- We expect Brazil-based electric utility group Energisa to continue improving its cash flow generation in the next few years, especially due to the favorable rate adjustments of its distributors, resulting in debt to EBITDA below 2.5x and funds from operations (FFO) to debt above 25%.
- We're affirming our 'BB-' global scale and 'brAAA' Brazil national scale ratings on Energisa and its subsidiaries.
- The stable outlook reflects the one on the sovereign, because the latter's credit quality caps the ratings on Energisa and on its subsidiaries.

Rating Action

On July 27, 2018, S&P Global Ratings affirmed its 'BB-' global scale and 'brAAA' Brazil national scale corporate credit ratings on Energisa S.A. and on its subsidiaries Energisa Paraiba-Distribuidora de Energia S.A. (Energisa Paraiba) and Energisa Sergipe-Distribuidora de Energia S.A. (Energisa Sergipe). The outlook remains stable. Energisa's 'bb+' stand-alone credit profile (SACP) remains unchanged.

Rationale

The 'bb+' SACP reflects our view that Energisa's cash flow generation will gradually improve in the next few quarters, especially as a result of the favorable rate readjustments for its distribution companies. This stems from the high level of investments the group made throughout its concession areas in order to improve the overall operating efficiency. We now expect Energisa to post a debt to EBITDA below 2.5x and FFO to debt above 25% over the next few years.

Although the group's SACP remains unchanged, the ratings on the Federative Republic of Brazil (BB-/Stable/B; brAAA/Stable/--) limit the corporate credit ratings on Energisa and on its subsidiaries. In our view, the Brazilian electric sector is highly regulated, especially the distribution and transmission segments, because the regulator (ANEEL) determines the rates for each company of the sector. We believe Energisa, as other regulated utilities

in Brazil, could be subject to government intervention in a scenario of sovereign default.

Energisa benefits from its distribution assets that operate as natural monopolies under a favorable regulatory framework. Energisa is one of the largest utility groups in Brazil, distributing electricity to about 6.7 million consumers in 788 municipalities. On one side, the group continues to improve the service quality of its existing assets through considerable investments, as seen in the duration and frequency of electricity service interruptions that are now in line with the regulatory standards in eight of the group's nine concession areas. Electricity losses are already under control among almost all of the group's distributors as well. On the other side, Energisa is pursuing a growth and diversification strategy, as seen in the group's winning of bids for two transmission assets in 2017 and one in 2018, which will result in additional investments of about R\$900 million mostly in 2020 and 2021. We believe Energisa will aim to continue expanding its operations in the electric sector, but will be prudent on the biddings in order to avoid weakening its credit metrics.

In 2017, Energisa's operating cash flow has been slightly above our expectations, as a result of the implementation of the rate resets in some of the group's distributors, while others will have their rates amended throughout 2018, which should help boost the consolidated cash flow generation.

In our base case scenario, we considered the following assumptions:

- Electricity demand in the group's concession area to grow by 3.0% in 2018 and 2.0% in 2019, reflecting Brazil's sluggish economic recovery;
- Distributors receiving rate adjustments above inflation, which we expect to be around 3.6% in 2018 and 4.0% in 2019, to reflect higher electricity costs and to compensate for higher investments.
- Annual investments of around R\$1.5 billion - R\$1.8 billion in the distribution and transmission segments.
- No acquisitions.
- A dividend payout of 50% of previous year's net income.

Based on these assumptions, we expect the following credit metrics for Energisa:

	2016A	2017A	2018E	2019E
EBITDA (mil. R\$)	2,658.60	2,394.10	2,700-2,900	2,900-3,100
Debt/EBITDA (x)	2	2.8	2.3-2.6	2.3-2.6
FFO/debt (%)	32.9	26.2	25-28	25-28
FOCF/debt (%)	-4.5	-9.5	0-5	0-5

A--annual. E--expected. FFO--funds from operations. FOCF--free operating cash flow.

We analyze Energisa on a consolidated basis based on our view that it has adopted an integrated financial strategy, and because it actively manages its subsidiaries' operations. We believe that Energisa Paraiba and Energisa Sergipe remain as some of the group's largest subsidiaries, given that we don't expect the group to dispose of its assets in the distribution segment, while Energisa continues investing to improve their operating efficiency. Therefore, we believe the ratings on both subsidiaries reflect the ones on Energisa.

Liquidity

We consider Energisa's liquidity as adequate. We expect its cash sources of to continue surpassing uses by more than 10%, and sources should continue to exceed uses even if EBITDA were to decline by 10% in the next 12 months. In addition, we believe Energisa has enough covenant headroom to absorb a drop of 10% of its EBITDA. Energisa has sound relationships with banks and easy access to debt markets, as seen in ongoing issuances of debentures by its operating subsidiaries. Given that the distribution segment could have seasonal working capital needs due to eventual timing mismatches on rate adjustments, Energisa has been maintaining a sizable cash position in order to absorb these potential costs with a limited need for refinancing. In addition, we believe the group could postpone its dividend payments in order to remain liquid.

Principal liquidity sources:

- Unrestricted cash reserves of about R\$2.1 billion as of March 31, 2018;
- Cash flow generation of about R\$1.8 billion in the next 12 months; and
- About R\$330 million of debt issued since March 2018.

Principal liquidity uses:

- Short-term debt of about R\$1.7 billion as of March 31, 2018;
- Minimum investments of about R\$1 billion for the coming years; and
- Flexibility to reduce the dividend payout to 35% if necessary.

Energisa has adequate covenant headroom under the financial covenants, including net debt to EBITDA and interest coverage ratios. Given that Energisa refinances its existing debt, it has been gradually changing its maximum net debt to EBITDA threshold to 4.0x, although some of its debt still has the 3.5x limitation.

Outlook

The stable outlook on Energisa and its subsidiaries reflects the one on the sovereign and incorporates our view that the group, as a regulated utility, could be subject to government intervention in a hypothetical sovereign default scenario. Given that Energisa Sergipe and Energisa Paraiba have the

same ratings as on Energisa, those ratings will move in tandem with the ones on the parent.

Downside scenario

If we were to downgrade Brazil in the next 12 months, we could downgrade Energisa and its subsidiaries ratings as well, given the regulated nature of their activities. We believe that a drop in Energisa's SACP could occur if the group pursues an aggressive debt-financed acquisition resulting in FFO to debt below 13% and debt to EBITDA above 4.5x amid a weakening liquidity, which would cause sources of cash to surpass uses by less than 20%.

Upside scenario

A positive rating action on Energisa would depend on a similar rating action on Brazil on the global scale, which we don't expect to occur in the next 12 months due to a stable outlook on the sovereign. We could revise upwards Energisa's SACP if the group can generate FOCF in the next few years while its FFO to debt remains above 30% and debt to EBITDA closer to 2.0x. The stronger credit metrics could stem from higher cash flows from the distribution companies, while the group maintains a conservative dividend policy, allowing Energisa to upstream a maximum of 50% of its previous-year net income.

Ratings Score Snapshot

Corporate Credit Rating:

- Global scale: BB-/Stable/--
- National Scale: brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Very Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)

- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-Alone Credit Profile (SACP): bb+

Ratings above the sovereign: BB-

Relationship between Energisa Paraiba and Energisa: Core

Relationship between Energisa Sergipe and Energisa: Core

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Energisa S.A.

Corporate Credit Rating

Global Scale

BB-/Stable/--

Brazil National Scale

brAAA/Stable/--

*Research Update: Energisa S.A. And Subsidiaries 'BB-' Global And 'brAAA' National Scale Ratings Affirmed;
Outlook Remains Stable*

Energisa Paraiba - Distribuidora de Energia S.A.

Corporate Credit Rating

Global Scale	BB-/Stable/--
Brazil National Scale	brAAA/Stable/--

Energisa Sergipe - Distribuidora de Energia S.A.

Corporate Credit Rating

Global Scale	BB-/Stable/--
Brazil National Scale	brAAA/Stable/--

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