

## **FITCH AFFIRMS ELETROPAULO'S IDRS AT 'BB'; OUTLOOK STABLE**

Fitch Ratings-Sao Paulo-22 September 2017: Fitch Ratings has affirmed Eletropaulo Metropolitana Eletricidade de Sao Paulo S.A.'s (Eletropaulo) Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB' and long-term National Scale Rating at 'AA-(bra)'. The Rating Outlook for the corporate ratings is Stable. A complete list of rating actions is included at the end of this press release.

### **KEY RATING DRIVERS**

Eletropaulo's ratings reflect its sound financial profile, underpinned by moderate leverage, manageable liquidity position and lengthened debt maturity profile. The company benefits from its business risk profile, in view of its exclusive rights to distribute electricity within its concession area in the Metropolitan Region of greater Sao Paulo. After a two-year reduction in energy demand in Eletropaulo's concession area, which resulted in a cumulative decrease of approximately 8%, the agency expects the consumption to resume growth in 2017, that along with some cost savings, will positively impact its operational cash flow generation.

Fitch's expectations that Eletropaulo's free cash flow (FCF) will be negative in the next two years limit the company's ratings. This assumption is based on the company's need for high capex and also on the return to customers, from July 2017 to June 2018, of higher revenues collected. The company's operational efficiency, measured by quality indicators based on the duration and frequency of supply disruptions, is currently above regulatory levels, which requires strong investments to bring them to acceptable levels. The ratings also incorporate the moderate regulatory and hydrological risk of the Brazilian electricity sector, which is currently above average.

**Moderate Leverage to Remain:** Fitch expects net leverage will remain at moderate levels in the range of 2.5 x-3.0x over the next three years. In the latest 12-month (LTM) period ended in June 2017, total debt/EBITDA was 3.9x, while net debt/EBITDA was 2.8x, compared with 4.5x and 3.1x, respectively, for 2016. Fitch's calculations do not incorporate BRL1.3 billion of debt related to pension fund obligations, which are included in company financial covenants, excluding pension fund expenses from EBITDA. Considering this adjustments on the calculation, net adjusted debt/EBITDAP would be 2.9x in June 2017.

**Manageable Negative Free Cash Flow:** Fitch expects negative FCF for Eletropaulo in 2017 and 2018 at around BRL450 million-BRL550 million, following the base case scenario that incorporates an increase in the annual average capex to the range of BRL1.0 billion-BRL1.2 billion in these years. Positively, the agency considers that the strong cash reserves of BRL931 million at the end of June 2017 can be used to manage this negative FCF. In the LTM ended on June 2017, cash flow from operations (CFFO) of BRL992 million was not enough to cover the capex of BRL1.0 billion and reduced dividends payment of BRL42 million, leading to a slightly negative FCF of BRL74 million.

Fitch does not expect non-recurring items, such as the discussion with the regulator related to a difference on its asset base adopted on the second Tariff Review Cycle and the loan debt involving Centrais Eletricas Brasileiras S.A. (Eletrobras) and Companhia de Transmissao de Energia Eletrica Paulista S.A. (CTEEP) to negatively impact Eletropaulo's cash flow generation. If those items materialize, the agency will review its projections.

Energy Consumption to Recover: Fitch estimates a recovery in consumption in Eletropaulo's concession area starting in 2017, which adds to operational cash generation, as a result of slightly improvement in the local economy. High energy tariffs and the challenging macroeconomic environment had negatively affected consumption levels in the last two years, with an accumulated reduction of around 8%. In the first semester of 2017, consumption in Eletropaulo's concession area declined 0.3% compared to the same period of previous year, with 3.2% and 4.7% decline in 2016 and 2015, respectively. The weak economy has also harmed the company in terms of a rise in delinquency, as well as high energy losses, which reached 9.6% in the LTM ended on June 2017, still above the regulatory limit of 9.4%.

EBITDA Below Regulatory Target: In the LTM ended on June 2017, EBITDA of BRL861 million remained significantly below the regulatory EBITDA estimate of BRL1.2 billion, defined during the last tariff review process in 2015. Most of this gap is explained by the pension fund expenses, along with the lower energy consumption in the concession area and penalties related to quality indicators below regulatory targets. The increase in capex level to improve service quality is a positive signal to meet the regulatory standards and reduce penalties in the future. Our scenario incorporates some productivity gains but we do not expect EBITDA to be under the regulatory level before 2019.

## DERIVATION SUMMARY

Eletropaulo's IDR of 'BB' compares favourably to Companhia Energetica de Minas Gerais' (Cemig) IDR at 'B+', as Cemig carries higher leverage and significant refinancing needs until the end of 2018. In relation to Energisa S.A.'s IDR of 'BB', it compares equal due to structural debt subordination of this holding company. When comparing to Energisa's consolidated distribution subsidiaries rated 'BB+', the last ones benefit from a more diversified asset base and improvement in the operational results after the acquisition of Group Rede distribution companies. Emgesa (Colombia) 'BBB' and AES Gener (Chile) 'BBB-', both operating in the electric generation segment, benefit from a better operating environment since their revenue generation and asset location are in investment grade countries. Nevertheless, AES Gener has an aggressive expansion program with some execution risk that explains the fact that the IDRs are on Rating Watch Negative.

## KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Consumption in the concession area increasing by 1% in 2017 and 2% in 2018 and 2019;
- CAPEX of BRL2.9 billion in from 2017 to 2019; and
- Minimum operational cash level of BRL500 million.

## RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

- EBITDA more in line with the regulatory level;
- Net leverage consistently below 2.5x;
- Cash and equivalents + CFFO/short-term debt ratio consistently above 2.0x.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Net leverage consistently above 3.5x;

- Cash and equivalents + CFFO/short-term debt ratio below 1.0x;
- Unexpected significant cash outflows due to litigation with CTEEP and Eletrobras;
- Unfavorable regulatory decisions;
- Any pressure coming from the controlling shareholder (AES Corp - BB-/Stable) for Eletropaulo to increase the dividends upstream, pressuring the company's credit metrics in comparison with Fitch's base case scenario.

## LIQUIDITY

Fitch considers that Eletropaulo presents a manageable liquidity profile. As of June 30, 2017, cash and marketable securities of BRL931 million was high and covered short-term debt of BRL640 million by 1.5x. Adding the CFFO registered in the LTM ended in June 2017, the short-term debt coverage was 3.0x. Nevertheless, the agency expects that the high forecasted capex should reduce the company's liquidity position in the coming two years. As a mitigating factor, Eletropaulo presents proven access to debt from the capital market and banks. The company also has around 80% of its flow of receivables free, which adds to financial flexibility.

## FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:

Eletropaulo Meropolitana Eletricidade de Sao Paulo S.A.

- Long-Term Foreign and Local Currency IDRs at 'BB';
- Long-Term National Scale Rating at 'AA-(bra)';
- 9th senior unsecured debentures issuance, in the amount of BRL250 million, at 'AA-(bra)';
- 11th senior unsecured debentures issuance, in the amount of BRL200 million, at 'AA-(bra)';
- 15th senior unsecured debentures issuance, in the amount of BRL750 million, at 'AA-(bra)';
- 20th senior secured debentures issuance, in the amount of BRL700 million, at 'AA-(bra)'.

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com). For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

## Applicable Criteria

Corporate Rating Criteria (pub. 07 Aug 2017)

<https://www.fitchratings.com/site/re/901296>

National Scale Ratings Criteria (pub. 07 Mar 2017)

<https://www.fitchratings.com/site/re/895106>

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