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Research Update:

Neoenergia S.A. 'BB' Ratings Affirmed; Outlook Still Negative

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Research Update:

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Overview

- We expect Neoenergia to post weaker credit metrics in the next few years, as a result of a combination of sizable investments and challenging macroeconomic conditions.
- We are affirming our 'BB' global scale and 'brAA-' national scale corporate credit ratings on Neoenergia. We are also affirming our 'brA-1' short-term national scale rating. We revised Neoenergia's stand-alone credit profile (SACP) to 'bb+' from 'bbb-'.
- The negative outlook on Neoenergia mirrors that of the sovereign.

Rating Action

On March, 30, 2016, Standard & Poor's Rating Services affirmed its 'BB' global scale and 'brAA-' national scale corporate credit ratings on Neoenergia S.A. and its core subsidiaries, Companhia de Eletricidade do Estado da Bahia (Coelba), Companhia Energetica de Pernambuco (CELPE), and Companhia Energetica do Rio Grande do Norte (Cosern). The outlook remains negative. We also affirmed our 'brA-1' short-term national scale rating.

At the same time, we affirmed our 'brA+' issue-level ratings on Neoenergia's subsidiaries, NC Energia S.A., Termopernambuco S.A. and Itapebi Geração de Energia S.A., based on the parent company's unconditional and irrevocable guarantee of these entities' notes.

Rationale

The SACP revision reflects our belief that Neoenergia's credit metrics will weaken relative to our previous expectations, as a result of the more challenging macroeconomic environment and higher debt to fund the group's sizeable capex plan, as well as the additional debt stemming from proportional guarantees to the Belo Monte and Teles Pires projects. In our view, Brazilian electricity distributors are vulnerable to the weakening of economic activity because it depresses electricity consumption, may lead to power surpluses, and higher delinquencies from end-users.

The ratings on Neoenergia are limited by the foreign currency rating on Brazil. In our view, Brazil's electricity sector is highly regulated, especially the distribution and transmission segments, because the regulator, Agencia Nacional de Energia Eletrica (ANEEL) sets the rates. We believe that

Neoenergia, as other regulated utilities in Brazil, could be subject to government interference under a sovereign default scenario, based on what we've seen with other countries in the region.

We withdrew our recovery ratings based on our understanding that Neoenergia, as a regulated electric utility, is not subject to Brazil's insolvency regime in case of default, unless after the concession expires, according with Law 12,767/2012. Despite of our view that, in general, a debt restructuring could maximize recoveries for the creditors, this law reduces the predictability in a default scenario for the regulated electric utilities. Issue-level ratings remain unchanged and we now use our traditional issue rating notching guidelines. Some of the group's senior unsecured debt issued at smaller subsidiaries but guaranteed by Neoenergia S.A. is rated a notch lower than the corporate credit rating, because of structural subordination, but this is somewhat mitigated by the existence of assets at the issuer level.

We analyze Neoenergia on a consolidated basis because we believe that it adopts an integrated financial strategy and the group's active management of the subsidiaries' operations. In 2015, Neoenergia posted debt to EBITDA of 3.3x and funds from operations (FFO) to debt of 25%. However, we expect credit metrics to weaken as a result of the more challenging macroeconomic environment and higher debt to fund the group's sizeable capex, including the proportional debt guarantees for the Belo Monte and Teles Pires projects. Under our base-case scenario, we expect debt to EBITDA to peak at around 4.5x in 2016 and FFO to debt to be about 13%.

In our base-case scenario for Neoenergia, we assumed the following:

- Electricity consumption growth to slow to about 2% in 2016 and 3% in 2017 as a result of weaker economic activity;
- Tariff readjustments based on inflation;
- Capex of about R\$2.3 billion in 2016 and 2017.
- Dividend payout of 25% of previous year net income until 2018.

Neoenergia's satisfactory business risk profile reflects the group's strong competitive position, due to its monopoly rights in large electricity distribution areas, which contributed around 80% of the consolidated EBITDA in 2015, and a proven and favorable regulatory framework, which we assess as adequate. The offsetting factor is Neoenergia's weaker operating efficiency relative to regulatory standards. Although Neoenergia's distribution companies have been investing in network maintenance to improve their operating performance, quality indicators and energy losses are consistently above the regulatory minimum.

Liquidity

We consider Neoenergia's liquidity as adequate. We expect sources of liquidity to exceed uses by at least 1.1x for the next 12 months, and the company should be able to comply with its financial covenants.

Principal Liquidity Sources:

- Cash position of R\$2.6 billion as of Dec. 31, 2015.
- Expected FFO generation of around R\$1.8 billion.
- Committed credit lines from development banks including the Brazilian Development Bank (BNDES) to fund approximately 50% of the group's investments.
- Existing R\$1 billion in bank loans has already been refinanced.

Principal Liquidity Uses:

- Debt maturities of around R\$2.9 billion in the next 12 months.
- Capex of up to R\$2.3 billion in 2016, more than 60% of which is for electricity distribution.
- Dividend payout of 25% of net income until 2018.

In our view, the group has adequate financial flexibility with proven access to the capital and bank markets, including attractive long-term financing from BNDES.

Outlook

The negative outlook on Neoenergia mirrors the sovereign rating outlook.

Downside scenario

If we were to downgrade Brazil, we could take the same rating action on the company. We could also downgrade Neoenergia if its credit metrics deteriorate in the next years, leading to FFO to debt consistently below 13% and adjusted debt to EBITDA consistently above 4.5x, coupled with a weaker liquidity position.

Upside scenario

The sovereign rating currently caps the rating on Neoenergia, and we don't foresee an upgrade potential in the short term. If we were to upgrade Brazil, we could take the same rating action on Neoenergia, if all else remains equal.

Ratings Score Snapshot

Corporate Credit Rating

Global Scale	BB/Negative/--
National Scale	brAA-/Negative/brA-1

Business risk: Satisfactory

- Country risk: Moderately High
- Industry risk: Low Risk
- 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: bb+

Related Criteria And Research

Related Criteria

- Standard & Poor's National And Regional Scale Mapping Tables, Jan. 19, 2016
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 01, 2010
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Neoenergia S.A.

Corporate Credit Rating

Global Scale

Brazil National Scale

BB/Negative/--

brAA-/Negative/brA-1

Commercial Paper

brA-1

Companhia Energetica de Pernambuco (CELPE)
 Companhia de Eletricidade do Estado da Bahia
 Companhia Energetica do Rio Grande do Norte

Corporate Credit Rating

Global Scale

BB/Negative/--

Brazil National Scale

brAA-/Negative/--

Companhia Energetica de Pernambuco (CELPE)

Senior Unsecured

Local Currency

brAA-

Recovery Rating

NR

3H

NC Energia S.A.

Senior Unsecured

Local Currency

brA+

Recovery Rating

NR

4H

Companhia de Eletricidade do Estado da Bahia

Senior Unsecured

BB

Itapebi Geracao de Energia S.A.

Subordinated

brA+

Termopernambuco S.A.

Senior Unsecured

brA+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

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