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Research Update:

Neoenergia S.A. And Its Subsidiaries 'BBB-' Ratings Affirmed; Outlook Remains Stable

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Overview

- Brazil-based electric utility Neoenergia has shown resilient cash flow and relative stable credit metrics in 2013.
- We are affirming our 'BBB-' global scale and 'brAAA' national scale corporate credit ratings on Neoenergia and its subsidiaries COELBA, CELPE and COSERN.
- We assess COELBA, CELPE and COSERN as "core" to their parent.
- The stable outlook is based on our expectation that the group will maintain its "adequate" liquidity position, with a minimum cash balance of R\$2 billion and cash-flow generation with funds from operations (FFO) of about R\$2.0 billion in the next two years.

Rating Action

On June 26, 2014, Standard & Poor's Rating Services affirmed its 'BBB-' global scale and 'brAAA' national scale corporate credit ratings on Neoenergia S.A. and its subsidiaries (Neoenergia). The outlook on the ratings is stable.

At the same time, we affirmed our 'brAA+' national scale issue ratings on the debt issued by Neoenergia's subsidiaries, 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

We analyze Neoenergia on a consolidated basis as we believe that it adopts an integrated financial strategy, and the holding company, Neoenergia, actively manages the operations at each of 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 ratings on Neoenergia reflect the strong growth prospects and stable cash flow from the distribution companies' concession areas, which contributed about 75% of the group's EBITDA in 2013. The group plans to expand its generation asset base to 4.0 gigawatts (GW) by 2019 from 1.6GW in 2013, which we view as positive in terms of business diversification. Nevertheless, we expect the distribution segment to continue to represent the majority of the group's sales and cash generation.

The ratings on Neoenergia are based on our view of the entire sector's strong

reliance on central government support, which weighs heavily in our analysis of its regulatory framework. Although Neoenergia did not suffer significantly from the extended drought in Brazil, the entire sector was exposed to a liquidity distress due to potential extraordinary working capital needs that did not materialize as the central government stepped in and provided additional funds to mitigate the stress. We believe Neoenergia's financial performance could weaken if the sector faced distress stemming from the extended drought. At the same time, we assess Neoenergia's liquidity as "adequate."

Neoenergia's business risk profile reflects the group's strong competitive position, due to its monopoly rights in large electricity distribution areas and a proven and favorable regulatory framework, which we assess as "adequate."

We view the distribution business as highly regulated and limited in scope, which adds stability and predictability to the group's future performance. The main risks are related to lower demand trends, but there are significant growth opportunities given the demographics in the group's concession areas, which are located in the country's northeast. Additionally, in April 2014, the local regulator (Agencia Nacional de Energia Elétrica; Aneel) approved a 17.75%, an average tariff adjustment for CELPE, 15.35% for COELBA, and 12.75% for COSERN, due to higher energy costs following the thermal dispatch in the last 12 months ended in April 2014, which was triggered because of the drought. We view the pass-through of the higher energy cost to tariffs, which was well above inflation for that period, demonstrates the strength of the regulatory framework and its ability to withstand political pressure during an election year. Neoenergia's competitive advantage is based on its robust scale and the geographic diversification of its distribution business, located in three of the largest states in terms of GDP in northeastern Brazil.

These positive factors are partially offset by Neoenergia's weaker operating efficiency compared to Aneel's standards. Although its distribution companies have been investing in network maintenance to improve their operational performance, quality indicators and energy losses are consistently non-compliant with the targets defined by the local regulator. As a result, we assess the operating efficiency as "adequate/weak."

We assess Neoenergia's financial risk profile as "intermediate" mainly because of its relatively strong and stable cash flow generation, which allows it to fund most of its aggressive capital expenditures (capex) and moderate dividends payout. For 2014, we expect debt to EBITDA to be about 3.0x and FFO to debt of about 22%, mainly due to the high energy prices related to the thermal dispatch. Despite its aggressive investment plan for the next five years (which will require additional debt), we expect Neoenergia to steadily improve its main cash-flow leverage metrics, resulting from stronger EBITDA of R\$2.3 billion-R\$2.5 billion in 2014, and R\$2.7 billion-R\$3.0 billion from 2015 onward, and prudent dividend distribution of 35%-50%. Under our base case scenario for 2015, we expect debt to EBITDA to decline to approximately 2.7x and FFO to debt to increase to 27%. Our base-case scenario for 2014 and 2015

includes:

- Consolidated revenue growth of about 16% in 2014, mainly a result of a tariff increase granted to the company's distribution companies in April 2014, and annual demand growth which is in line with GDP growth of 1.8% in 2014 and 2.0% in 2015;
- From 2015 onward, we expect revenues to rise following the ramp-up of new generation projects, such as Teles Pires in 2015 and Baixo Iguaçu in 2016, which will add new cash flow generation to the group, resulting in a gradual recovery of leverage ratios;
- Annual capex of R\$2.3 billion-R\$2.6 billion; and
- Dividend payout of 35%-50%.

Liquidity

We assess Neoenergia's liquidity as "adequate." As of Dec. 31, 2013, the group had a cash position of R\$2 billion, which was more than sufficient to cover its R\$852 million in short-term maturities. We expect the group to maintain a minimum cash position of R\$2 billion while it implements its growth strategy. In general, Neoenergia has good financial flexibility, enjoying frequent access to capital markets.

Principal Liquidity Sources

- FFO of R\$1.5 billion-R\$1.7 billion in 2014;
- Committed credit lines from the national development bank (BNDES; foreign currency: BBB-/Stable/--), Banco do Nordeste do Brasil S.A. (BNB; foreign currency: BBB-/Stable/--), Centrais Elétricas Brasileiras SA (Eletrobras; foreign currency: BBB-/Stable/--) to fund approximately 50% of the group's investments; and
- Minimum cash position of R\$2 billion.

Principal Liquidity Uses

- Minimum working capital outflows;
- Capex up to R\$2.6 billion (approximately 55% in electricity distribution) in 2014; and
- Dividend payments to remain at 35%-50% to cope with the planned investments and in line with the group's dividend policy.

The company has established more flexible financial covenants, with net debt to EBITDA revised to 4.0x from 3.0x in order to absorb the impact of the lower weighted average cost of capital (WACC) following the third review cycle, and the effect of the volatility of the EBITDA calculated by international financial reporting standards (IFRS), which does not consider the regulatory assets and liabilities adjustment. Neoenergia has applied the 4.0x net debt to EBITDA covenant to all its new debt issuances from December 2013 onwards, while it has negotiated a waiver on its ancillary debt, including the loans provided by BNDES, to 3.5x net debt to EBITDA.

In addition, we believe the group has a comfortable capital structure, with an average debt maturity life of around four years, and a smooth amortization profile. All foreign currency debt is 100% hedged, and the group has access to

relatively cheap long-term financing provided by BNDES, BNB, and Eletrobras.

The BNDES financing typically includes a cross default clause that entitles it to accelerate a financing agreement if any obligation before the BNDES and the subsidiaries of a controlling company pertaining to the economic group defaults. We derive the rating on Neoenergia from consolidated accounts, which include all of its subsidiaries. We believe that in the hypothetical case of a smaller non-rated subsidiary's default, which could trigger an acceleration of BNDES loans to the group (these loans totaled R\$3.7 billion as of Dec. 31, 2013), Neoenergia has strong incentives to support the potential weaker subsidiary and the ability to withstand this scenario due to its ample liquidity.

Our issue-level senior unsecured debt rating based on Neoenergia's guarantee is one notch below the issuer credit rating (ICR) on the group, incorporating the structural subordination to priority liabilities at the operating subsidiaries' level.

Outlook

The outlook is stable, based on our expectation that Neoenergia will continue to generate strong cash flows, with minimum FFO of R\$1.5 billion-R\$2.0 billion in the next two years, mainly coming from electricity distribution, which contributes about 75% of the consolidated EBITDA.

The outlook incorporates the group's aggressive investment plan for the next five years concentrated in the distribution segment and in the development of already committed generation assets. Despite expected higher debt, the outlook reflects our expectation that Neoenergia will maintain debt to EBITDA less than 3.5x, FFO to debt will reach a minimum of about 22% in 2014, recovering to 27% in 2015. We also expect Neoenergia to maintain it "adequate" liquidity and over 10% headroom in its financial covenants ratios.

Downside scenario

We could downgrade Neoenergia if it is unable to gradually reduce leverage with FFO to debt lower than 25% by the end of 2015, or if it presents a dividend payout higher than 50%, which could further weaken the group's financial flexibility, leading to a deterioration of its liquidity assessment to "less than adequate," and/or resulting in debt to EBITDA more than 3.5x and FFO to debt consistently lower than 25% in the next two years.

Upside scenario

At this point, an upgrade is unlikely given the sovereign's credit quality.

Ratings Score Snapshot

Corporate Credit Rating:

Global scale rating	BBB-/Stable/--
Brazil national scale	brAAA/Stable/--

Business risk: Satisfactory

- Country Risk: Moderately High
- Industry Risk: Low Risk
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

Group credit profile: bbb-

Related Criteria And Research

Related Criteria

- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Guarantee Criteria--Structured Finance, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Neoenergia S.A.

Companhia de Eletricidade do Estado da Bahia

Companhia Energetica do Rio Grande do Norte

Companhia Energetica de Pernambuco (CELPE)

Corporate Credit Rating

Global scale rating BBB-/Stable/--

Brazil National Scale brAAA/Stable/--

Companhia Energetica de Pernambuco (CELPE)

Senior Unsecured brAAA

Companhia Energetica do Rio Grande do Norte

Subordinated brAAA

Companhia de Eletricidade do Estado da Bahia

Senior Unsecured BBB-

Senior Unsecured brAAA

Itapebi Geracao de Energia S.A.

Subordinated brAA+

Termopernambuco S.A.

Senior Secured brAA+

Senior Unsecured brAA+

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