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Research Update:

Neoenergia S.A. Outlook Revised To Negative From Stable, 'BBB-' Rating Affirmed On Weaker Financial Risk Profile

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Overview

- Credit metrics of Brazil-based electric utility Neoenergia have weakened in 2014 due to the drought, but we expect a recovery in 2015.
- We revised our outlook on Neoenergia and its subsidiaries, Coelba, Celpe, and Cosern, to negative from stable because of our concern about the aggressive financial policy and vulnerability to non-controllable factors, given tighter cash position and higher debt for the rating category, which could weaken the group's overall liquidity.
- We are affirming our 'BBB-' global scale and 'brAAA' national scale corporate credit ratings on Neoenergia.

Rating Action

On March, 31, 2015, Standard & Poor's Rating Services revised its outlook on Neoenergia S.A. and its subsidiaries, Companhia de Eletricidade do Estado da Bahia (Coelba), Companhia Energetica de Pernambuco (CELPE), and Companhia Energetica do Rio Grande do Norte (Cosern), to negative from stable. We also affirmed our 'BBB-' global scale and 'brAAA' national scale corporate credit ratings on these companies.

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

Rationale

The outlook revision reflects our concern about the group's aggressive financial policy and vulnerability to non-controllable factors, given its tighter cash position and higher debt for the rating category, which could weaken the group's overall liquidity.

We analyze Neoenergia on a consolidated basis because we believe that it adopts an integrated financial strategy and Neoenergia's active management of the subsidiaries' operations.

We have revised our financial risk profile assessment on Neoenergia to "significant" from "intermediate" due to its more aggressive leverage ratios.

Even though the group's consolidated debt to EBITDA of 5.5x and funds from operations (FFO) to debt of 11% in 2014, considering S&P adjustments to the reported figures, these weak metrics reflect the drought's cost of about R\$828 million for the group in 2014, which none of the government support mechanisms covered. We expect the recent extraordinary tariff increase and the tariff readjustment to compensate for this cost in 2015 and afterwards, resulting in EBITDA of about R\$2.4 billion, which is in line with Neoenergia's historical average. Still, under our base-case scenario, we expect its debt to EBITDA of 3.9x at the end of 2015 and about 3.0x in 2016 and FFO to debt of 16% and 22% respectively, which are in line with the "significant" category. Our base-case scenario for 2015 and 2016 includes the following:

- Consolidated revenue growth of about 26% in 2015, mainly as a result of the tariff increases for the group's distribution companies, including the already granted extraordinary tariff hike of 5.36% for Coelba, 2.21% for Celpe, and 2.76% for Cosern, along with an about 15% tariff readjustment in April. The growth rate includes the ramp-up of the Teles Pires plant from the second half of 2015, which will add cash flow generation to the group, resulting in a gradual recovery of its leverage ratios.
- Capex of R\$2.5 billion in 2015 and R\$2.3 billion in 2016.
- Dividend payout of 35%-50%.

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 about 80% of the consolidated EBITDA in 2014, 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 performance. The main risk is a lower demand, but group's concession areas, which are located in the country's northeast, benefit from significant growth opportunities. Additionally, we view as positive the regulator's recent tariff framework, which should reduce the distributors' working capital needs because the new rates will reflect on a timely basis the effective cost of electricity for these companies.

Neoenergia's competitive advantage is based on its distribution business which serves three of the largest states in terms of GDP in northeastern Brazil. The mitigating factor is Neoenergia's weaker operating efficiency than 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. As a result, we assess the operating efficiency as "adequate/weak."

Even though the group is investing to expand its generation capacity 4.0 gigawatts (GW) from 1.6 GW by 2019, we still expect the distribution segment to continue to represent the majority of the group's sales and cash generation.

Liquidity

We assess Neoenergia's liquidity as "adequate." As of Dec. 31, 2014, the group had a cash position of R\$1.2 billion, which will cover R\$1.2 billion in short-term maturities. We expect the group to maintain a cash position equivalent to its short-term maturities. In general, Neoenergia still has solid financial flexibility, enjoying frequent access to both banking and capital markets.

Principal Liquidity Sources:

- FFO of R\$1.5 billion in 2015 and R\$2.0 billion in 2016.
- Committed credit lines from the Brazilian Development Bank (BNDES), Banco do Nordeste do Brasil S.A. (BNB), Centrais Eletricas Brasileiras SA (Eletrobras) to fund approximately 50% of the group's investments.
- Refinancing of existing R\$1 billion in bank loans.

Principal Liquidity Uses:

- Minimum working capital outflows as tariffs should more effectively reflect energy costs. Despite expected higher delinquency rates in 2015, we expect the group to control them.
- Capex of up to R\$2.5 billion in 2015, more than 60% of which is for electricity distribution, and R\$2.3 billion in 2016.
- Dividend payments of R\$300 million in 2015 and 2016, in line with the financial policy guidance of a 35%-50% payout under current leverage ratios.

We view that the group has some flexibility in its financial covenants, following the regulator's approval to recognize Neoenergia's regulatory assets and liabilities in its 2014 fiscal results.

In addition, we believe the group has a comfortable capital structure, with an average debt maturity life of about three years and a smooth amortization profile. The group hedges all of its foreign currency debt, and it has access to relatively cheap long-term financing from BNDES, BNB, and Eletrobras.

The BNDES financing typically includes a cross default clause that entitles it to accelerate repayment if any obligation before the BNDES and the subsidiaries of a controlling company pertaining to the economic group defaults. We believe that under such scenario, Neoenergia has strong incentives to support its potentially weaker subsidiary, while it has the ability to withstand this scenario due to its ample liquidity and access to other sources of financing.

Due to Neoenergia's guarantee, our issue-level senior unsecured debt ratings on the subsidiaries are one notch below the corporate credit rating, incorporating the structural subordination to priority liabilities at the operating subsidiaries' level.

Outlook

The outlook is negative. We view negatively the group's aggressive financial policy, with prospective credit metrics more aligned with a "significant" financial risk profile assessment, despite Neoenergia's commitment to reduce its debt. The group's growth and dividend payments have been aggressive, despite significant costs from the drought since September 2012. On the other hand, although we believe that the group should reduce leverage in 2015 and afterwards given the new tariff framework, it still depends on the management's financial policy to perform it, while in 2013 and 2014 it relied mostly on government's support to avoid further increasing its leverage. The negative outlook also reflects the group's vulnerability to non-controllable factors, given its tighter cash position and increased leverage, which could impact both its debt covenants and overall liquidity position.

Downside scenario

We could downgrade Neoenergia if it can't reduce its debt, resulting in FFO to debt of less than 13% and debt to EBITDA of more than 4.5x in 2015 and 2016, and/or if its liquidity weakens from higher working capital needs and dividend payments, prompting us to revise our liquidity assessment to "less than adequate."

Upside scenario

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

Ratings Score Snapshot

Corporate Credit Rating

Global Scale	BBB-/Negative/--
National Scale	brAAA/Negative/--

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

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)

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Industry Risk, 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; CreditWatch/Outlook Action

	To	From
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	BBB-/Negative/--	BBB-/Stable/--
Brazil National Scale	brAAA/Negative/--	brAAA/Stable/--

Ratings Affirmed

Companhia Energetica de Pernambuco (CELPE)	
Senior Unsecured	brAAA
Companhia de Eletricidade do Estado da Bahia	
Senior Unsecured	BBB-
Itapebi Geracao de Energia S.A.	
Subordinated	brAA+
Termopernambuco S.A.	
Senior Unsecured	brAA+

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