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Research Update:

Eletrobras' Stand-Alone Credit Profile Revised Down To 'bb-' On Santo Antonio's Consolidation, 'BB-' Ratings Affirmed

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Rating Action Overview

- Furnas, a fully owned subsidiary of Centrais Elétricas Brasileiras S.A. - Eletrobras (or the company), will start including Santo Antonio Energia S.A.'s (SAESA) results in its financial reports following an indirect capitalization that will boost Furnas' ownership of SAESA to about 70% from 43%.
- We believe that SAESA's consolidation will hurt Eletrobras' financial metrics because the project is highly leveraged (as of March 31, 2022, its debt rose to R$19.4 billion at an average cost of IPCA plus 7.23% per year). In our view, the pace of Eletrobras' deleveraging will depend on the execution of its asset divestment strategy. These factors prompted the downward revision of the company's stand-alone credit profile (SACP) to 'bb-' from 'bb'.
- Still, on June 1, 2022, S&P Global Ratings affirmed its 'BB-' global scale issuer credit and issue-level ratings on the Brazilian electric utility. We also affirmed our 'brAAA/brA-1+' national scale ratings.
- The stable outlook reflects our expectation that Eletrobras will continue deleveraging in the upcoming 12-24 months through the proceeds of sales of non-core assets, while it keeps improving its operating performance. We forecast adjusted debt to EBITDA of about 5.0x and funds from operations (FFO) to adjusted debt 7%-9% in 2022-2023, including the consolidation of SAESA.

Rating Action Rationale

The company's reports will start consolidating those of SAESA following the capitalization. Furnas and other equity holders of SAESA have a track record of supporting the project through capitalizations pro rata to their ownership shares. Still, on May 31, 2022, Furnas was the sole shareholder to have committed a required R$1.5 billion capital increase at SAESA, approved under an extraordinary shareholder meeting on April 29, 2022. As a result, Furnas became the project's majority shareholder, increasing its stake to about 70% from 43%.

SAESA owns the concession of UHE Santo Antonio until October 2047. This run-of-river hydro plant is located on the Madeira River, with 3.5 gigawatt (GW) of installed capacity and sold its 2.4 GW assured energy under long-term power purchase agreements (PPAs) in regulated (70%) and free markets (30%). As of March 31, 2022, SAESA's debt totaled R$19.4 billion, with an average cost of IPCA plus 7.23% per year.

We expect Eletrobras' credit metrics to weaken. Our adjusted debt for Eletrobras already includes about R$31 billion of financial guarantees it provides to special purpose entities (SPEs) that it doesn't control, of which R$8.4 billion corresponds to SAESA. After making pro forma adjustments to consolidate SAESA's cash flows and debt, we now forecast Eletrobras' adjusted debt to EBITDA to increase to about 5.0x and funds from operations (FFO) to adjusted debt to drop to 7%-9% in 2022-2023 from 3.5x-4.0x and above 12%, respectively. The new metrics prompted us to revise our assessment of the company's financial risk profile to highly leveraged from aggressive.

We also believe that the pace of Eletrobras' deleveraging will slow down, because its FFO will take a hit from higher interest expenses and increased debt following the consolidation of SAESA's high debt. Nonetheless, we believe leverage could decrease if the company continues to sell its non-strategic assets, such as the disposal of shares of publicly traded companies that totaled about R$9.1 billion as of March 31, 2022 (net of sale of its 32.66% shares in CEEE-T in April 2022 for R$1.1 billion).

Eletrobras continues with the privatization process. On May 18, 2022, Brazil's federal audit court approved the company's privatization model. We don't incorporate it in our base-case scenario, given uncertainties over the process, including market appetite and minimum price that the government would accept.

If the proposed privatization is implemented, with governance standards that includes limits on the government's influence on the company's administrative and strategic decisions, we could revise our assessment of the link between Eletrobras and the government, which we currently view as very strong. All else remaining equal, that would trigger a downward revision of our assessment of an extraordinary likelihood of support in case of financial distress to high or lower from extremely high.

Outlook

The stable outlook reflects our expectation that Eletrobras will continue deleveraging in the next 12-24 months through the proceeds of sales of non-core assets, while it keeps improving its operating performance. We forecast adjusted debt to EBITDA of about 5.0x and FFO to adjusted debt of 7%-9% in 2022-2023, including SAESA's results. The outlook also reflects our view that even if the likelihood of receiving extraordinary government support further diminishes once, and if, the company's privatization occurs, our issuer credit rating on it will remain unchanged, because its intrinsic capacity to repay debt remains equal to the one of the sovereign.

Downside scenario

We could lower our ratings on Eletrobras in the next 12 months if we lower the sovereign rating on Brazil. Absent any sovereign rating action, a downgrade could result from a weakening of Eletrobras' liquidity if, for example, amid privatization Eletrobras is unable to issue new capital to cover the R$25.4 billion grant fee for the new concessions and the R$5.0 billion Conta do Desenvolvimento Energetico Account payment due in 30 days after the privatization's completion. We could also lower the rating if the divesture program takes longer to materialize, given that we expect the company to continue reducing its debt through the proceeds of asset sales in the next few years.

Upside scenario

The sovereign rating on Brazil caps the ratings on Eletrobras. We could revise upwards the SACP in the next 12-18 months if the company completes its divestment program, improving its operating and financial performance, resulting in adjusted net debt to EBITDA consistently below 5.0x and FFO to net debt above 12%.

Company Description

Eletrobras is Brazil's national integrated electric utility that focuses on generation (with 50.5 GW in installed capacity) and transmission (74,087 kilometers [km]), which represented about 60% and 40% of its 2021 revenue, respectively. The government holds directly and indirectly 72.2% of the company's voting share and 61.7% of total capital.

Our Base-Case Scenario

- Brazil's GDP growth of 0.6% in 2022, 1.6% in 2023, 1.9% in 2024, and 2.0% afterwards (according to our latest economic conditions article, "Global Macro Update: Growth Forecasts Lowered On Longer Russia-Ukraine Conflict And Rising Inflation", May 17, 2022).
- Brazil's average inflation of 10.6% in 2022, 4.9% in 2023, 3.7% in 2024, and 3.0% afterwards. We forecast the Brazilian central bank's policy interest rates to peak at 13.25% by the end of 2022 and gradually fall to 6.5% in 2025, as inflation eases.
- Consolidation SAESA's 2.4 GW assured energy sold at contracted prices and its R$19.4 billion debt at average cost of IPCA plus 7.23%. We also consider the existing stand-still agreement with BNDES on the interest and principal payments.
- About R$6 billion in annual indemnification of non-depreciated transmission assets, regarding the early renewal of the concessions (RBSE) in 2022 and 2023.
- Annual cash capital expenditures (capex) of about R$2 billion in 2022 and R$4 billion in 2023.
- Capital increase in SAESA of R$1.5 billion.
- Minimum annual dividend of R$2.5 billion.

Based on these assumptions, we arrive at the following credit metrics for 2022-2023:

- Annual FFO of R$5.5 billion - R$6.5 billion;
- Adjusted debt to EBITDA of about 5.0x; and
- FFO to adjusted debt of 7%-9%.

We analyze Eletrobras on a consolidated basis and make several adjustments to its debt, including guarantees provided to non-consolidated companies/projects (about R$21 billion, net of the guarantees provided to SAESA) and pension fund contingencies (about R$6.1 billion).

Liquidity

We continue to assess Eletrobras' liquidity as adequate. We expect cash sources over uses to be well above 1.2x for the next 12 months, and for the company to comply with debt covenants. Moreover, in our view, the company has adequate access to the capital markets, and while it maintains a robust cash position, unexpected cash outlays, including settlement of judicial disputes, can weaken its financial flexibility.

Sources of liquidity:

- Net cash and equivalents of R$15.2 billion as of March 2022 (excluding R$3.2 billion in restricted cash);
- Cash FFO of about R$7.0 billion in the next 12 months;
- A new R$1.5 billion seven-year committed loan that Furnas secured in May 2022; and
- R$1.1 billion from the sale of a 32.66% stake in CEEE-T.

Uses of liquidity in the next 12 months:

- Debt maturities of R$8.2 billion, as of March 31, 2022;
- Working capital outflows of R$1.5 billion;
- Minimum capex of R$2.1 billion;
- Capital increase in SAESA of R$1.5 billion; and
- Dividend distribution of R$1.3 billion.

Covenants

The company is subject to financial covenant under its debentures of a maximum net debt to adjusted EBITDA of 3.75x. This is measured on an annual basis, and net debt is adjusted to deduct the financial asset related to Itaipu. The covenant calculation also excludes guarantees provided to non-consolidated projects and pension-related liabilities. We believe Eletrobras will comply with this covenant over the next few years with a sufficient cushion. In addition, Furnas is seeking bondholders' approval on the capitalization of SAESA, which will be higher than 5% of its EBITDA, as defined in the debenture indenture.

Issue Ratings - Subordination Risk Analysis

The senior unsecured debt ratings are at the same level as our issuer credit ratings on the company, given its strong relationship with the government and that according to the domestic legislation, government-related entities (GREs) aren't subject to reorganization.

We rate Eletrobras' following debt instruments:

- $500 million senior unsecured notes due February 2025;
- $738 million senior unsecured notes due February 2030;
- R$5 billion second debentures with final maturity in 2029; and
- Furnas's R$1.25 billion debentures, guaranteed by Eletrobras.

Ratings Score Snapshot

Issuer credit rating: BB-/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Highly Leveraged

- Cash flow/leverage: Highly Leveraged

Anchor: b+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1)
- Stand-alone credit profile: bb-

Related government rating: BB-

Likelihood of government support: Extremely high (no impact)

Rating above the sovereign: (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas

Industry, March 28, 2014

- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- 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, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

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Ratings Affirmed		
Eletrobras-Centrais Eletricas Brasileiras S.A.		
Issuer Credit Rating	BB-/Stable/--	
Brazil National Scale	brAAA/Stable/brA-1+	
ELETRONORTE		
Senior Unsecured	brAAA	
Eletrobras-Centrais Eletricas Brasileiras S.A.		
Senior Unsecured	BB-	
Senior Unsecured	brAAA	
Furnas - Centrais Eletricas S.A.		
Senior Unsecured	brAAA	
	To	**From**
Eletrobras-Centrais Eletricas Brasileiras S.A.		
Analytical Factors	**bb-**	**bb**