Research Update:

Eletrobras' Stand-Alone Credit Profile Revised Up To 'bb' On Improved Operations, 'BB-' Rating Affirmed On Sovereign Cap

April 13, 2022

Rating Action Overview

- Centrais Elétricas Brasileiras S.A. - Eletrobras has gradually improved its operational performance since 2017, by reducing operating costs and focusing on its core generation and transmission business, while it continues to dispose its non-strategic assets, as seen in its recent sale of its stake in Companhia Estadual de Transmissão de Energia Elétrica (CEEE-T) for R$1.1 billion.
- We expect the company to continue reducing leverage, with adjusted debt to EBITDA dropping to 3.5x-4.0x and funds from operations (FFO) to adjusted debt rising above 12%. This leverage target, coupled with our expectation that the business will continue to exhibit relatively robust operating performance, supports our upward revision of the financial risk profile to aggressive from highly leveraged which prompted the upward revision of the stand-alone credit profile (SACP) of the company to 'bb' from 'bb-'.
- On April 13, 2022, S&P Global Ratings affirmed its 'BB-' global scale issuer credit and issue-level ratings on the Brazilian electric utility, because the sovereign rating caps our ratings on Eletrobras, given that we consider it a government-related entity (GRE) with an extremely High likelihood of receiving extraordinary government support. We also affirmed our 'brAAA/brA-1+' national scale ratings.
- The outlook on Eletrobras remains stable, mirroring that on the sovereign. The outlook also reflects our view that even if the likelihood of receiving extraordinary government support further diminishes as the capitalization advances, our issuer credit rating on Eletrobras will remain unchanged thanks to the influence of the Brazilian regulations, which we currently view as supportive.

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Rating Action Rationale

Despite higher provisions for contingencies in 2021, we expect Eletrobras to continue strengthening its financial performance in the next two to three years. Eletrobras has been reducing its costs, and sales and administrative expenses since 2017. In addition, it reduced its workforce to 12,126 by December 2021 from 21,563 in December 2017. Moreover, Eletrobras sold its eight distribution companies that generated EBITDA losses, while it shrunk its investment portfolio to 81 special purpose entities (SPEs) by December 2021 from 175 in December 2017. At the same time, Eletrobras' provisions for contingencies reached a record high of R$14.9 billion in 2021, including R$10.9 billion for its compulsory loans. Due to these factors, Eletrobras generated R$9.5 billion in EBITDA (a 27% margin), while its adjusted debt to EBITDA rose to 6.5x and FFO to adjusted debt dropped to 7% in 2021. Excluding non-recurring items, adjusted EBITDA would have been around R$14 billion (a 39% margin) and FFO to adjusted debt at around 14%. Such metrics would have aligned with EBITDA of R$13.6 billion (a 43% margin), adjusted debt to EBITDA of 5.1x, and FFO to adjusted debt of 12% in 2020.

In April 2022, Eletrobras completed the sale of its 33% stake in CEEE-T for R$1.1 billion, as part of its strategy of focusing on its core generation and transmission businesses, while it divests its non-strategic assets. Going forward and according to our base case forecasts, we expect the company to continue reducing leverage, evidenced by adjusted debt to EBITDA at 3.5x-4.0x and FFO to adjusted debt above 12% in the next two years. These metrics are commensurate with a healthier financial risk profile and therefore, we revised our assessment of the company's financial risk profile to aggressive from highly leveraged, resulting in the upward revision of the SACP that is now 'bb'.

Capitalization can restrict government influence. We believe that the proposed privatization framework, with capitalization through primary and secondary share offerings until the government's share is diluted to a maximum of 45% of Eletrobras' voting shares, and consequent change in the company's bylaws should limit the government interference in Eletrobras' strategic and management decisions. Under the proposed privatization framework, a single shareholder (direct or indirect) will have its voting rights limited to 10%. In addition, there will be a poison pill mechanism to limit the ownership by any shareholder to 30%, and the government will retain a golden share with sole purpose of exercising veto to any changes to the new corporate bylaws - in particular, the one that limits single or multiple shareholder voting rights to 10% of the voting rights. This should allow dilution of the majority control of the company and limit influence on its governance.

Until the privatization is completed, we continue to assess the likelihood of Eletrobras receiving extraordinary government support as extremely high. This assessment still reflects a high degree of influence of the company's controlling shareholder, the sovereign and its incentives, capacity, and tools to support Eletrobras, if necessary. We base this assumption on the following factors:

- We continue to view Eletrobras's critical role in the Brazilian electricity sector. The company is Brazil's largest integrated electric utility, accounting for about 30% of total generation capacity and 40% of transmission lines in the country. Given its size and considerable time to replace and/or build new assets, we believe that these services couldn't be undertaken by another entity in the medium term. For example, a disruption of Eletrobras' transmission lines could have a deep economic impact on the country. Therefore, we believe that the government has incentives to support.
- A very strong link to the government. While the government guarantees just 3% of Eletrobras' debt--loans from multilateral institutions such as the World Bank--the government has a track record of providing cash injections in periods of financial distress. Given that the government is

the controlling shareholder of Eletrobras, we continue to view the government as exerting influence, until a capitalization and the government's share dilution materializes. The latter depends not only on administrative approval (including by TCU, the federal audit authority), but also on market sentiment, given the presidential election in October 2022.

Additional advancement of the privatization process would likely diminish the currently very strong link, given the board's greater independence, while likely have lesser impact on role given the company's key role in supplying electricity to the Brazilian market.

Outlook

The stable outlook on Eletrobras 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 higher than of the sovereign. The outlook also reflects our expectation that Eletrobras will continue deleveraging through the proceeds of sales of non-core assets, while it keeps improving its operating performance. This should result in adjusted debt to EBITDA of 3.5x-4.0x and FFO to adjusted debt above 12% in the next 12 months.

Downside scenario

We would lower the ratings on Eletrobras if we were to lower our sovereign rating on Brazil. Absent any sovereign rating action, we could revise downward the company's SACP if adjusted debt to EBITDA were to remain above 5.0x and FFO to adjusted debt below 12%, which could occur if its capital structure weakens due to a more aggressive financial policy, which we don't anticipate at this point.

Upside scenario

While the sovereign rating on Brazil caps the one on Eletrobras, we could revise again upward the SACP in the next 12-18 months upon progress in the company's divestment program and improvement of its operating performance and capital structure, resulting in adjusted debt to EBITDA consistently below 4.0x and FFO to adjusted debt above 20%. However, such a scenario wouldn't prompt the rise in the issuer credit rating unless we upgrade the sovereign.

Company Description

Eletrobras is Brazil's national integrated electric utility that focuses on generation (with 50.5 gigawatts [GW] in installed capacity) and transmission (74,087 kilometers [km]), which represent about 60% and 40% of its 2021 revenues, 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 0.4% in 2022, 1.7% in 2023, and 2.0% afterwards (according to our latest economic conditions article, " Economic Outlook Latin America Q2 2022: Conflict Abroad Amplifies Domestic Risks ", dated March 28, 2022).

- Brazil's average inflation of 8.3% in 2021, 8.9% in 2022, and 4.1% in 2023. 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.
- 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 around R$2 billion in 2022 and R$4 billion in 2023.
- Minimum annual dividend of R$2.5 billion.

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

- EBITDA of R$16 billion – R$18 billion;
- Adjusted debt to EBITDA of 3.5x-4.0x; and
- FFO to adjusted debt of above 12%.

We analyze Eletrobras on a consolidated basis and make several adjustments to its debt, including guarantees provided to non-consolidated companies/projects (about R$30 billion) 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 covenants to remain compliant. In our view, the company has adequate access to the capital markets, and while it maintains a robust cash position, but unexpected cash outlays, including settlement of judicial disputes, can weaken its financial flexibility.

Sources of liquidity:

- Net cash and equivalents of R$15.8 billion as of December 2021 (excluding R$2.5 billion restricted cash);
- Cash FFO of R$7.7 billion in the next 12 months; 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;
- Working capital outflows of R$1.5 billion;
- Capex of R$2.1 billion;
- Dividend distribution of R$2.5 billion.

Covenants

The company is subject to a maximum net debt to adjusted EBITDA of 3.75x financial covenant under its debentures. 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 the company will comply with this covenant over the next few years with a sufficient cushion.

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$5.0 billion second debentures issuance with final maturity in 2029; and
- R$1.25 billion debentures of Furnas, guaranteed by Eletrobras.

Capital structure

Eletrobras' capital structure consists of about R$44 billion of consolidated financial debt, about 55% at the holding level. In addition, the debentures issued by Furnas, Chesf, CGT Eletrosul and Eletronorte are guaranteed by Eletrobras. There's no material secured debt collateralized by real assets.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/--

Business risk: Satisfactory

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

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bb

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: Neutral (no impact)
- Stand-alone credit profile: bb

Related government rating: BB-

Likelihood of government support: Extremely high (capped)

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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

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

	To	From
Eletrobras-Centrais Eletricas Brasileiras S.A.		
Analytical Factors	**bb**	**bb-**

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.