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EDP Energias do Brasil S.A.

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EDP Energias do Brasil S.A.

Credit Highlights

Issuer Credit Rating

None

Overview

Key strengths	Key risks
An integrated electricity group operating in the generation and distribution segments, while increasing its presence in the transmission segment.	Energy losses at its distributors still above regulatory targets.
The generation segment's limited exposure to hydrology risk, given insurance and that a portion of its assured capacity is uncontracted.	Poor hydrology conditions could weigh on its distributors, because higher energy costs are not immediately incorporated into rates.
Brazil's favorable regulatory framework.	

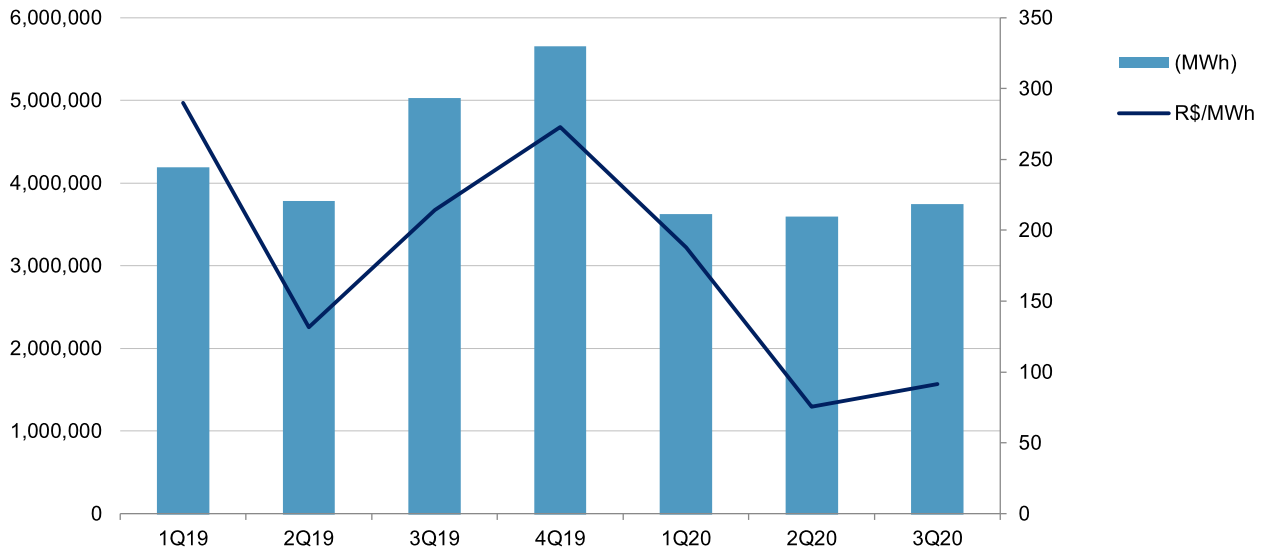
Credit Highlights

Several measures offset the COVID-19 impact on EDP Brasil. EDP Energias do Brasil S.A. (EDP Brasil)—which controls the two distribution companies EDP São Paulo Distribuição de Energia S.A. (EDP São Paulo) and EDP Espírito Santo Distribuição de Energia S.A. (EDP Espírito Santo)—is an integrated energy conglomerate, focusing on electricity distribution, generation, and commercialization, while it recently started operating in the transmission segment. The pandemic-induced economic shock and social-distancing measures reduced overall energy consumption in Brazil in the first months of the pandemic, causing energy sales in EDP Brasil's concession areas to decrease by 6.8% in the first nine months of 2020. This was mainly due to the drop in energy demand in the industrial and commercial segments of 9.8% and 12.5%, respectively. Nevertheless, EDP São Paulo and EDP Espírito Santo benefited from R\$574 million the government funding, which was part of "Conta Covid", an off-balance financing program to address the liquidity squeeze among the distributors suffering from adverse effects of the pandemic. In addition, the electricity sector regulator, ANEEL, approved the average annual rate adjustment of roughly 8% for EDP Espírito Santo in early August and 4.82% for EDP São Paulo in late October. We note EDP Brasil is taking initiatives to mitigate the impact from the pandemic, including cost reduction, capex postponement, and debt refinancing in order to preserve cash and lengthen its debt maturity profile. Moreover, although delinquency rates increased, the impacts were moderate, given that provisions for non-paying customers ticked up to 0.76% in the first nine months of 2020 from 0.65% for the same period in 2019, as a percentage of gross revenues.

A smaller effect from COVID-19 on the generation segment. We believe generators are better positioned than distributors to withstand the sharp downturn caused by the pandemic, because the former usually sell energy through long-tenor, take-or-pay contracts with solid counterparties in the regulated and free markets. While the pandemic didn't have a significant impact on the regulated market because distributors have received financial support, this is not necessarily the case for the portion of the energy sold in the free market, which negotiates at spot prices, and counterparty risk under bilateral sales agreements. EDP Brasil adhered to a law to protect its output from hydrology risks whenever the Generation Scaling Factor (GSF) falls below 92%, which helps make cash flows more predictable. Nevertheless, as we had expected, the group's energy sales dropped 15.7% in the first nine months of 2020 because of lower demand for energy following the termination of some bilateral contracts, and lower average energy spot prices.

Chart 1

Energy Sales And Average Spot Prices In Brazil's Southeast/Midwest Subsystem

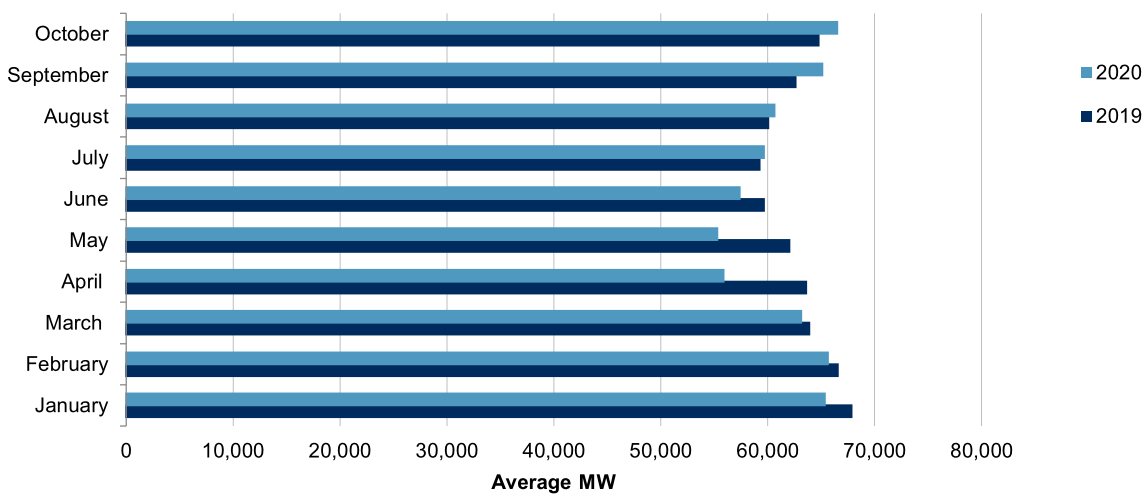


Source: S&P Global Ratings.

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Credit metrics to improve starting in 2021 as energy demand recovers and the transmission assets become operational.

Energy consumption in Brazil has been recovering since July 2020. We expect this trend to continue as economy starts to rebound next year. In addition, EDP Brasil will enjoy additional cash flows from its new transmission lines starting in 2021. The group has invested about R\$3.5 billion to extend them to 1,440 kilometers (km). We assess this as a credit strength, given the steady cash flows from the transmission segment. We expect the group to post net debt to EBITDA of 2.2x-2.4x in 2020 and in the mid-2.0x area in 2021.

Chart 2**Monthly Energy Consumption In Brazil (Average MW)**

MW--Mega watt. Source: S&P Global Ratings.

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Improving asset quality metrics. EDP Brasil continues to make significant investments in its electricity distributors to improve their operating efficiency. Overall, duration and frequency of service interruptions are shrinking and within regulatory limits. However, the non-technical electricity losses for EDP Espírito Santo were 13.02% as of Sept. 30, 2020, above the regulatory target of 11.56%. Losses have widened during the pandemic, especially non-technical losses, because inspection reports were temporarily suspended in order to avoid contagion risk for employees and customers. The group has been gradually resuming its initiatives to curb losses.

Outlook

The stable outlook on EDP Espírito Santo and EDP Sao Paulo reflects that on the sovereign rating on Brazil, given that we cap the ratings on both companies at the sovereign rating level, considering the regulated nature of their businesses.

Downside scenario

Given that we cap the ratings on EDP Espírito Santo and EDP Sao Paulo at the sovereign level, if we were to downgrade Brazil in the following 12 months, we expect a similar rating action on both companies. Currently, we don't envision a scenario in the next 12 months that could lead to a downgrade of the distributors stemming from their stand-alone fundamentals. However, a downgrade could occur if we believe that the ultimate parent has less incentive to provide support to its Brazilian operations and if EDP Brasil's credit metrics deteriorate, such as funds from operations (FFO) to debt below 12% and debt to EBITDA above 5.0x, which could result from a large debt-financed acquisition.

Upside scenario

An upgrade of EDP Espírito Santo on the global scale in the next 12 months would be contingent to a positive rating action on the sovereign rating on Brazil, while everything else remaining unchanged. In addition, if the parent, EDP - Energias de Portugal (EDP Portugal; BBB-/Stable/A-3), provides explicit support to its Brazilian operations, we could also upgrade EDP Espírito Santo on the global scale. The national scale ratings on EDP Espírito Santo and EDP Sao Paulo are already at the top of the Brazil national scale, so there's no upside scenario in this case.

Our Base-Case Scenario

Assumptions

- Because of the pernicious effects from the COVID-19 pandemic, we've revised our assumptions for energy consumption, which should drop 4%-5% in 2020, followed by an increase of 3.5% and 3.0% in 2021 and 2022, respectively, in line with our expectation of Brazil's GDP trajectory.
- Following the rate adjustment of 8% for EDP Espírito Santo and 4.8% for EDP São Paulo, and the government financial support, we currently don't assume any extraordinary readjustment of rates for EDP Brasil's distributors in 2020. For 2021 and 2022, rates to increase in line with our expectations for inflation of approximately 3.0% and 3.5%, respectively.
- Sales from the distribution segment 5.5%-6.5% below the 2019 level.
- GSF, which determines the group's level of energy delivery, of 82.0% in 2020 and 92.0% starting in 2021.
- The ramp-up of the transmission segment during 2020 and higher cash flows from it starting in 2021 and 2022. Only two lines are operational at this point, which represent less than 15% of total availability.
- Capex of about R\$1.7 billion in 2020 and about R\$2.0 billion in 2021, most of it for the transmission segment and improvement of distributors' operating efficiency.
- A dividend payout of 50% of previous year's net income, in line with its new dividend policy, in which EDP Brasil will monitor its leverage, measured by net debt to EBITDA, by aiming for the 2.5x-3.0x level.

Based on these assumptions, we expect EDP Brasil to post the following adjusted credit metrics (which exclude the regulatory accounts flowing to the income statement, but we incorporate them in our projections based on our expectation of monetization, if it's an asset, or as cash outflow, if it's a liability):

- Adjusted net debt to EBITDA of 2.2x-2.4x in 2020 and in the mid-2.0x area in 2021; and
- FFO to net debt at low of 30% in 2020 and 2021.

Base-case projections

We analyze EDP Espírito Santo and EDP Sao Paulo based on EDP Brasil's consolidated figures, given our view that the group adopts an integrated financial strategy and actively manages its subsidiaries' operations.

Company Description

EDP São Paulo and EDP Espírito Santo are two distribution companies controlled by the electric power integrated group EDP Brasil (not rated) that generate, distribute, trade, and transmit electricity. EDP São Paulo has monopoly rights to serve the captive market of 28 cities in the state of São Paulo until October 2028. In the rolling 12 months ended on Sept. 30, 2020, EDP São Paulo distributed approximately 14,801 gigawatt hours (GWh) to its almost 2 million clients. EDP Espírito Santo has the monopoly rights to provide electricity to the captive market of 70 cities in the state of Espírito Santo until July 2025, and distributed 9,500 GWh of electricity to its 1.6 million clients for the same period. Given the monopolistic characteristics of the electric power distribution services in Brazil, market share doesn't necessarily indicate efficiency, given that the concession areas are determined by the contracts with the granting authority - the Ministry of Mines and Energy.

The generation segment producing electricity through hydro and thermal power is the group's biggest cash flow contributor. Its portfolio totals 2.32 GW of installed capacity (1.56 GW of assured energy), out of which 720 MW are from thermal generation and the remaining portion is hydro. It also has non-controlling stakes in three operating hydro plants: Cachoeira Caldeirão (219 MW), Jari (393 MW), and São Manoel (700 MW).

EDP Brasil entered the transmission segment in 2016, when it started to participate in concession bids to build and operate transmission lines. Construction of the bulk of the lines that the group won should be completed in the next few years and should start contributing to cash flows starting in 2021.

EDP Brasil is controlled by the Portuguese power group EDP Portugal, which has 51.2% of shares. The remaining shares are free floating.

Business Risk

A favorable regulatory framework. We view the regulatory framework in Brazil as credit supportive. ANEEL is responsible for setting the rates for distribution and transmission companies. Rates are set in order to remunerate the investments made in the concession area. Rate setting for transmitters is simpler, because these companies receive revenues according to their availability to the system. Given that the distribution companies currently operate under a model of pass-through costs, along with the remuneration of their investments, they receive rate readjustments every three to five years (depending on the concession contract). Rate readjustments allow the companies to pass through to the clients the electricity costs incurred, and general and administrative-related expenses, which are pegged to inflation. Rate reviews incorporate efficiency gains during the cycle, which are shared with the customers. In each

cycle, the regulator sets a new weighted average cost of capital (WACC) to remunerate the investments during the concession. Distribution companies also have the right to request an extraordinary rate review in order to recover the financial and economic rebalancing of the concession contract.

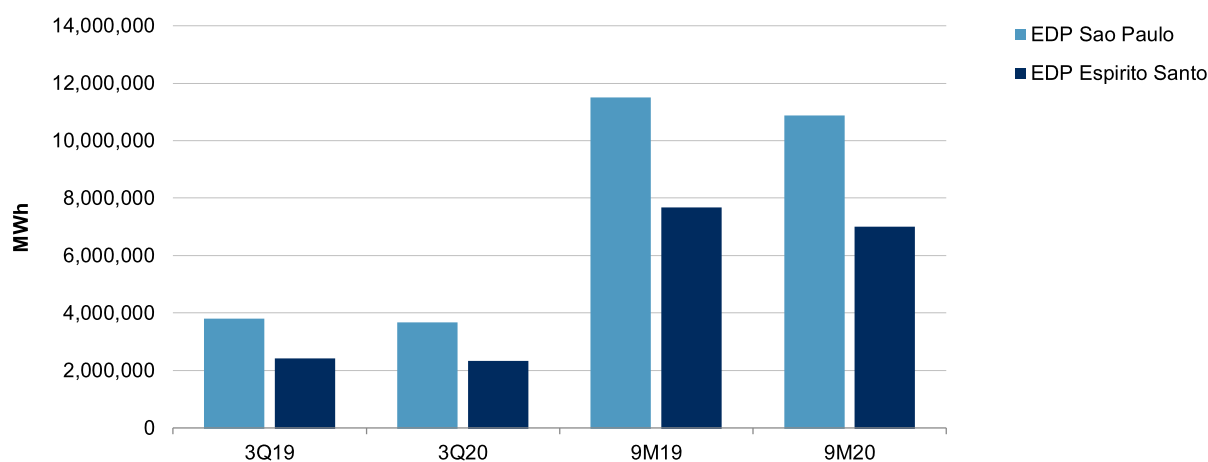
We believe that power generators tend to mitigate cash flow volatility through long-term power sale contracts to distribution companies and large users. The generation segment of EDP Brasil has a diversified asset base with hydro and thermal power plants, combining short- and long-term power purchase agreements signed in the free and regulated market, respectively. In 2016, EDP Brasil adhered to a law to protect its generation from hydrology risks whenever the GSF falls below 92%, which helps make cash flows more predictable. For the free market, it maintains about 15% of its assured energy uncontracted, underscoring a conservative energy hedge strategy. Nevertheless, low energy demand and spot prices during the nine months of 2020 caused EDP Brasil's sales in the generation segment to contract 15.7% compared with the same period of last year.

The customer base of EDP Brasil's distributors mainly consist of residential clients, a category that's less exposed to economic downturn. During the first nine months of 2020, demand among the residential clients increased 2.6% compared with that of the same period in the previous year, because of social-distancing measures and the higher amount of time people spent home. Nevertheless, lower consumption among industrial and commercial clients more than offset resulted in a drop of 8.7% for the same period.

Both distribution companies are not significantly exposed to spot market prices or to a specific supplier, with the exception of Itaipu (which we don't consider a risk). Following the investments in the past few years, EDP Brasil's distributors are improving the quality metrics in their concession areas, with average duration and frequency of service interruptions within the regulatory limits. However, losses at EDP Espírito Santo are consistently wider than the regulatory limits for the concession area, so the gap between regulatory and effective losses isn't passed on to the rates.

Chart 3

Distributed Volume

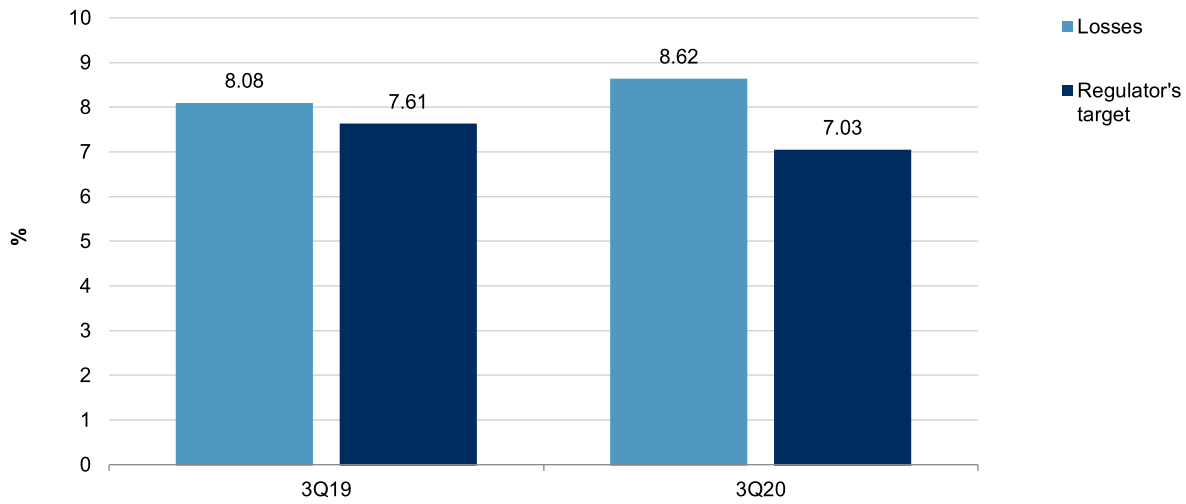


Source: S&P Global Ratings.

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Chart 4

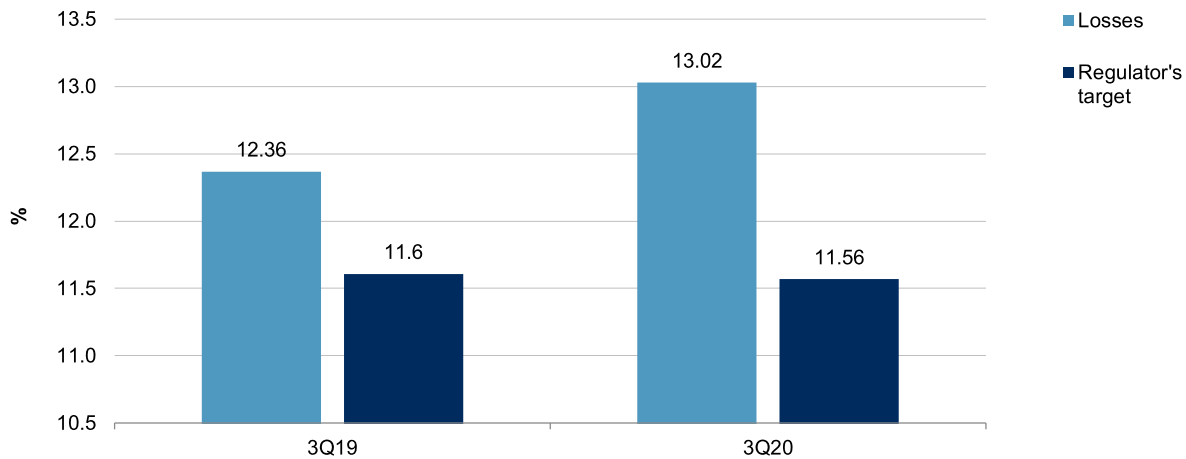
EDP São Paulo's Total Losses



Source: S&P Global Ratings.
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Chart 5

EDP Espírito Santo's Total Losses



Source: S&P Global Ratings.
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Table 1

EDP Energias do Brasil S.A.--Peer Comparison

Industry sector: Electric utility

	EDP Energias do Brasil S.A.	CPFL Energia S.A.	Neoenergia S.A.	EDP - Energias de Portugal S.A.
Ratings as of Oct. 21, 2020			BB-/Stable/--	BBB-/Stable/A-3
	--Fiscal year ended Dec. 31, 2019--			
(Mil. \$)				
Revenue	3,120.2	7,230.5	6,367.7	16,084.2
EBITDA	734.8	1,881.8	1,701.7	3,804.4
Funds from operations (FFO)	518.9	1,353.9	1,305.0	2,869.5
Interest expense	195.6	369.6	330.8	767.7
Cash interest paid	121.7	288.1	316.0	654.9
Cash flow from operations	509.8	1,433.7	848.2	1,954.6
Capital expenditure	544.5	556.5	1,071.9	2,581.8
Free operating cash flow (FOCF)	(34.7)	877.2	(223.6)	(627.3)
Discretionary cash flow (DCF)	(178.0)	744.4	(397.2)	(1,693.5)
Cash and short-term investments	690.1	693.6	1,011.4	1,662.8
Debt	1,832.4	4,449.2	4,513.0	19,081.3
Equity	2,570.3	3,304.6	4,791.2	15,157.3
Adjusted ratios				
EBITDA margin (%)	23.5	26.0	26.7	23.7
Return on capital (%)	14.9	21.2	16.0	6.5
EBITDA interest coverage (x)	3.8	5.1	5.1	5.0
FFO cash interest coverage (x)	5.3	5.7	5.1	5.4
Debt/EBITDA (x)	2.5	2.4	2.7	5.0
FFO/debt (%)	28.3	30.4	28.9	15.0
Cash flow from operations/debt (%)	27.8	32.2	18.8	10.2
FOCF/debt (%)	(1.9)	19.7	(5.0)	(3.3)
DCF/debt (%)	(9.7)	16.7	(8.8)	(8.9)

We chose peers that also operate in the Brazilian electric sector, such as CPFL Energia S.A. and Neoenergia S.A., which operate in the distribution, generation, and transmission segments. When comparing the three entities, we view EDP Brasil as the most exposed to the generation segment, which could be riskier if the group hasn't contracted hydrology insurance. Additionally, we believe that EDP Brasil will report lower leverage than Neoenergia and similar to that of CPFL. EDP Brasil began investing in the transmission segment earlier, and should benefit from it in 2020, which should increase the predictability of the cash flows and reduce leverage before its peers do.

Financial Risk

We expect COVID-19 to have a limited impact on EDP Brasil's financial metrics. We expect the group's net debt to EBITDA to reach 2.2x-2.4x in 2020 from 2.5x in 2019. Besides the government funding, the group reduced operating

costs, postponed capex, reduced dividends distribution, and issued close to R\$1.6 billion throughout 2020 to improve its cash position and lengthen its debt amortization profile, which explains slightly stronger credit metrics. In addition, EDP Brasil is finalizing the construction of its transmission lines, which will bring additional cash flows. As a result, we expect debt to EBITDA at mid-2.0x and FFO to debt at high 20% in 2021.

Financial summary

Table 2

EDP Energias do Brasil S.A.--Financial Summary					
Industry sector: Electric utility					
(Mil. \$)	--Fiscal year ended Dec. 31--				
	2019	2018	2017	2016	2015
Revenue	3,120.2	3,303.4	3,393.0	3,086.3	2,441.8
EBITDA	734.8	632.1	556.6	1,004.4	462.4
Funds from operations (FFO)	518.9	441.7	304.4	645.2	264.0
Interest expense	195.6	174.4	215.4	242.4	177.4
Cash interest paid	121.7	116.8	192.1	217.6	158.1
Cash flow from operations	509.8	337.6	223.8	498.5	237.7
Capital expenditure	544.5	280.1	228.8	186.4	102.5
Free operating cash flow (FOCF)	(34.7)	57.5	(5.1)	312.1	135.2
Discretionary cash flow (DCF)	(178.0)	(77.4)	(133.5)	139.4	55.4
Cash and short-term investments	690.1	614.2	517.8	619.8	290.3
Gross available cash	690.1	614.2	517.8	619.8	290.3
Debt	1,832.4	1,908.5	2,108.3	1,782.9	1,788.4
Equity	2,570.3	2,499.0	2,727.8	2,759.9	1,890.3
Adjusted ratios					
EBITDA margin (%)	23.5	19.1	16.4	32.5	18.9
Return on capital (%)	14.9	14.1	9.3	21.4	17.5
EBITDA interest coverage (x)	3.8	3.6	2.6	4.1	2.6
FFO cash interest coverage (x)	5.3	4.8	2.6	4.0	2.7
Debt/EBITDA (x)	2.5	3.0	3.8	1.8	3.9
FFO/debt (%)	28.3	23.1	14.4	36.2	14.8
Cash flow from operations/debt (%)	27.8	17.7	10.6	28.0	13.3
FOCF/debt (%)	(1.9)	3.0	(0.2)	17.5	7.6
DCF/debt (%)	(9.7)	(4.1)	(6.3)	7.8	3.1

Liquidity

We assess EDP Brasil's liquidity as adequate. We expect the group's sources of liquidity to surpass its uses by more than 20% in the next 12 months. In addition, we expect the difference between sources and uses of cash to remain positive even if the expected EBITDA is 15% lower than in our base-case scenario. Despite the significant maturities in the next 12 months, EDP Brasil's cash position is more than enough to cover them, in our view. Also, the group has well-established relationships with banks and wide access to debt markets, as shown in the subsidiaries' recent

issuances totaling R\$1.6 billion either through capital markets or banks.

We believe the group has the appropriate mechanisms in place to face any high-impact, low-probability event with limited need for refinancing. The group reduced the dividend payout to 27.81% of net income from 47.59% in 2020, and postponed investments in its transmission lines during the pandemic, given the advanced progress of works.

Principal Liquidity Sources

- R\$3.3 billion in cash and equivalents as of Sept. 30, 2020; and
- R\$2.1 billion in cash FFO in the next 12 months.

Principal Liquidity Uses

- R\$3 billion in debt maturities in the next 12 months, as of Sept. 30, 2020;
- About R\$1 billion in maintenance capex; and
- Payouts of 50% of the previous year's net income, following the group's new dividend policy.

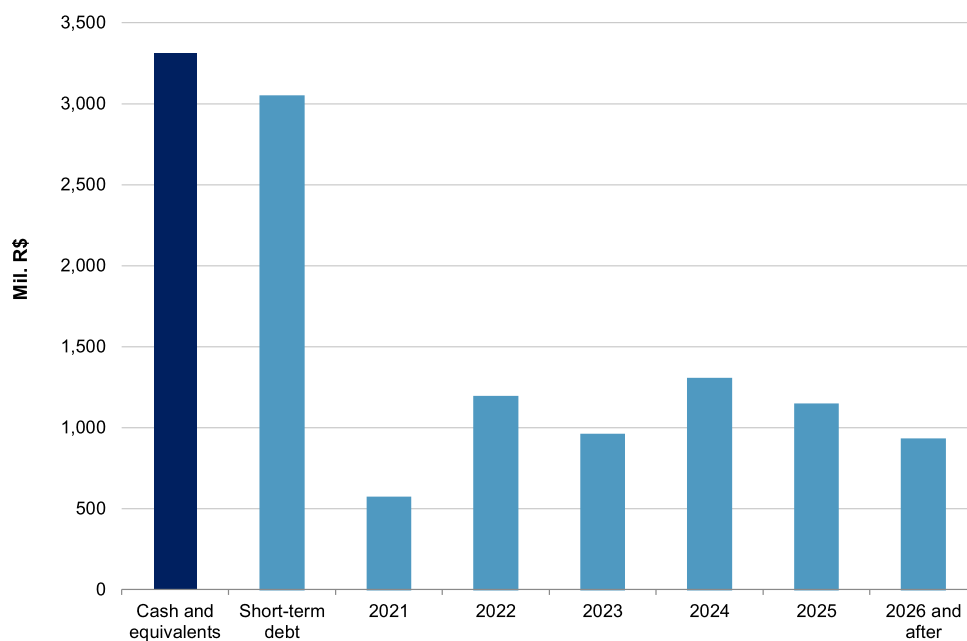
Debt maturities

EDP Brasil has the following consolidated debt maturity schedule as of Sept. 30, 2020:

Chart 6

Debt Amortization Schedule

As of Sept. 30, 2019



R\$--Brazilian real. Source: S&P Global Ratings.

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Covenant Analysis

Compliance expectations

We expect EDP São Paulo and EDP Espírito Santo to remain in compliance with their financial covenants in the next three years based on their likely low leverage metrics.

Requirements

Both EDP Espírito Santo and EDP São Paulo have financial covenants on some of their debt obligations that limit the subsidiary level net debt to adjusted EBITDA to 3.5x, measured annually with the end-of-year financial statements.

Environmental, Social, And Governance

We believe that one of the most important aspects in our analysis of EDP Brasil is the social factor, because an interruption in the distribution of electricity affects the population. EDP Espírito Santo and EDP São Paulo have certain requirements to comply with, in terms of maximum duration and frequency of service interruptions. If these requirements are not met, cash flows would suffer. In addition, EDP Brasil operates the thermal plant PECEM (not rated), which could have a negative impact on the environment, given that it uses mineral coal as fuel. However, because it's only dispatched when hydrology is low, we don't consider this plant to have a major impact on the environment.

Group Influence

Both EDP São Paulo and EDP Espírito Santo are core subsidiaries of EDP Brasil, because they are fully owned and the distribution segment represents about 50% of total EBITDA. EDP Brasil accounts for about 20% of EDP Portugal's consolidated revenue, which mainly operates in Portugal, Spain, the U.S., Canada, and Brazil.

Reconciliation

Table 3

Reconciliation Of EDP Energias do Brasil S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$)

--Fiscal year ended Dec. 31, 2019--

EDP Energias do Brasil S.A. reported amounts

	Debt	Shareholders' equity	Revenue	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
Reported	2,105.9	2,296.0	3,788.5	741.9	587.2	179.0	734.8	622.8
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	--	(94.1)	--
Cash interest paid	--	--	--	--	--	--	(121.7)	--

Table 3

Reconciliation Of EDP Energias do Brasil S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$) (cont.)								
Accessible cash and liquid investments	(690.1)	--	--	--	--	--	--	--
Income (expense) of unconsolidated companies	--	--	--	(17.0)	--	--	--	--
Nonoperating income (expense)	--	--	--	--	47.0	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	--	(113.0)
Noncontrolling interest/minority interest	--	274.3	--	--	--	--	--	--
Debt: Guarantees	273.0	--	--	--	--	--	--	--
Debt: Workers compensation/self insurance	124.5	--	--	--	--	--	--	--
Debt: Tax liabilities	19.1	--	--	--	--	--	--	--
Revenue: Other	--	--	(668.3)	(668.3)	(668.3)	--	--	--
COGS: Other nonoperating nonrecurring items	--	--	--	644.3	644.3	--	--	--
EBITDA: Other	--	--	--	33.7	33.7	--	--	--
Interest expense: Other	--	--	--	--	--	16.6	--	--
Working capital: Taxes	--	--	--	--	--	--	--	94.1
Working capital: Other	--	--	--	--	--	--	--	36.1
Operating cash flow: Taxes	--	--	--	--	--	--	--	(94.1)
Operating cash flow: Other	--	--	--	--	--	--	--	(36.1)
Total adjustments	(273.5)	274.3	(668.3)	(7.2)	56.8	16.6	(215.9)	(113.0)
S&P Global Ratings' adjusted amounts								
	Debt	Equity	Revenue	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	1,832.4	2,570.3	3,120.2	734.8	644.0	195.6	518.9	509.8

Ratings Score Snapshot

EDP Espírito Santo:

- Global Scale: BB-/Stable/--
- National Scale: brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately High Risk

- Industry risk: Intermediate Risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Stand-alone credit profile (SACP): bb+

Group rating methodology:

Between EDP Espírito Santo and EDP Brasil: Core

EDP São Paulo:

- National Scale: brAAA/Stable/--

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral

- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Group rating methodology:

Between EDP Sao Paulo and EDP Brasil: Core

Related Criteria

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Ratings Detail (As Of November 19, 2020)*

EDP Energias do Brasil S.A.

Related Entities

EDP Espirito Santo Distribuicao de Energia S.A.

Issuer Credit Rating

BB-/Stable/--

Brazil National Scale

brAAA/Stable/--

Ratings Detail (As Of November 19, 2020)*(cont.)**EDP Sao Paulo Distribuicao de Energia S.A.**

Issuer Credit Rating

Brazil National Scale

brAAA/Stable/--

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