

Brazilian Utilities

Meeting Cemig, Tractebel, Light, AES Tiete and Eletropaulo – Key takeaways

Equities

Latin America
Utilities

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We met 5 top mgmt. teams in our III LatAm Infrastructure Conference in NYC

Key highlights: 1. Power prices are on the rise for 2015+ (positive for Gencos); 2. Rationing risks are still high for 2015 given only moderate rainfall pick-up and despite slower demand growth (negative for 2015e for Gencos' costs, and small negative for Discos' revenues); 3. Demand growth seems to be decelerating strongly (negative for Discos); 4. Debt costs have gone up by c100-150bps, as the R\$6.5bn in new loans to Discos on top of the R\$11bn issued via CCEE in April (to cover for non-controllable cost hikes) have increased banks' risk exposure to the sector. 5. Earnings visibility remains low since 4Q12 (MP579) and improvements in outlook are uncertain. There was no bold new news in the past 3m to justify, in our view, recent sector rally - the strong performance could be attributed to fund flows into EM.

Higher long-term power prices, on still high shortage risks

Our R\$120-125/MWh power price assumptions for 2016+ seem light when taking into account mkt prices of c.R\$200-145-135-115/MWh for 2016-17-18-19, respectively. As an offset, hydrological risks remain high, and our assumption of 5% hydro generation shortfall for 2015e might prove too low; it is however early to change it given unpredictable hydrology. To reiterate, if it rains >80% of long-term average (LTA) in Nov-Apr then Gencos don't need to buy much energy at expensive spot prices, but if it rains c.60% (as was the case earlier this year), we see need to cut demand by 10-20%. In the near-term, different monthly sales volume allocation strategies can yield very varying results as seen in 1Q and 2Q results.

Valuation: still cautious on the sector

We see fixed income yields as more attractive than equity div. yields for Bz ute. We also see small-only improvements in sector regulatory risks ahead. These underpin our cautious stance on the sector, and many of our SELL ratings. Our favourite stocks within LatAm are Cteep, Aes Tiete ON, Energias. We also like IEnova in Mexico, where we are more comfortable in paying for growth given benign macro/sector dynamics and more reasonable outlook for project returns.

Stock Picks

Buy ratings: AES TIETE ON, CTEEP, ENERGIAS DO BRASIL.

CTEEP: We like CTEEP at current levels, in view of: 1) positive cash flows in 2013+ despite the c.70% drop in revenues with the extension of its concession contract thru 2042, on lean opex; 2) re-leverage upside with the R\$2.9bn upfront receivables from the Bz Fed Govt regarding post-2000 investments - co has today net cash; 3) further leverage upside (towards 3.5x net debt-EBITDA) when company receives compensation for non-depreciated investments for asset built pre-2000 (R\$3-3.6bn as per CTEEP); 4) growth opportunities coming from Brazil's need to invest R\$32bn in grid expansion thru 2020e, although we note that company will not make any further investments in Brazil until made whole by the Bz Fed Gov.; 5) possibility of stopping c.R\$140-160m p.a. pension payments to former Sao Paulo state employees that are due by the Sao Paulo State Government (this is currently under dispute) and recovering a c.R\$500m balance. Finally, we also note that CTEEP's cash flows are insulated from rising rationing risks in Brazil due to capacity-based revenues and low default risks from its Disco clients.

AES TIETE ON: Strongest and most defensive cash flow and high payout/yield through 2015YE, and even a bear case of poor hydrology wherein TIETE would have to unfairly pay for a higher safety in the Brazilian system. With dividend yields of c.11-13% thru 2015e, we remain comfortable that the company will still be able to offer 7.5% yield (in real R\$ terms) for 2016+, based on re-pricing of its energy contracts at gross R\$110/MWh price (down from current >R\$170/MWh). Finally, with changes in the rules of the game caused by MP579 and poor hydrology, we see upside to this long-term power price assumption. ADTV remains a concern under the current market environment, and rising rationing risks seem to be already reflected in the stock price with the recent poor performance.

ENERGIAS DO BRASIL: Quality name with 50/50 exposure to genco/disco offering genco volume growth upside from new projects and already priced-in reduction in short term cash flows coming from the 3rd tariff reset at Discos and operational problems faced by coal-fired Pecem I plant. With the parent's 2012 corporate restructuring and the recent JV in generation with CTG in Brazil, we believe the local ENERGIAS DO BRASIL management team will increase focus on growth generation projects at a similar, positive investment discipline we have seen in the past. The recent bid for the R\$1.1bn Caldeirao or for the R\$2.7bn Sao Manoel hydro projects are coming at a 7-8% targeted ROE, which seems reasonable under current global environment for a 30-yr period, assuming execution risks turn out to be low and overcome as guided by management.

NEUTRAL: AES TIETE PN, CPFL ENERGIA, COPEL, ENEVA, IENOVA, LIGHT.

SELL: CEMIG, CESP, SABESP, COPASA, ELETROPAULO, EQUATORIAL ENERGIA, TRACTEBEL ENERGIA.

Statement of Risk

Given its regulated nature, the electricity sector is subjected to political or legal interference. The federal and state governments could implement changes or apply more severe rules to the tariff reset process that could negatively affect companies' cash flows, and/or incentivize/penalize new-builds in renewables as opposed to gas or coal, for instance. Finally, an abrupt change in the macroeconomic scenario including FX weakness could negatively impact valuation for foreign investors, as tariffs are basically denominated in local currency (although adjusted by inflation annually).

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Neutral	FSR is between -6% and 6% of the MRA.	41%	30%
Sell	FSR is > 6% below the MRA.	11%	23%
UBS Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 June 2014.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
AES TIETE (ON)	GETI3.SA	Buy	N/A	R\$16.23	29 Jul 2014
AES TIETE (PN)	GETI4.SA	Neutral	N/A	R\$19.25	29 Jul 2014
CEMIG ¹⁶	CMIG4.SA	Sell	N/A	R\$19.05	29 Jul 2014
CESP ^{5, 13}	CESP6.SA	Sell	N/A	R\$30.36	29 Jul 2014
COPASA ¹³	CSMG3.SA	Sell	N/A	R\$37.33	29 Jul 2014
COPEL ¹⁶	CPL6.SA	Neutral	N/A	R\$37.32	29 Jul 2014
CPFL Energia ¹⁶	CPFE3.SA	Neutral	N/A	R\$20.42	29 Jul 2014
ELETROPAULO	ELPL4.SA	Sell	N/A	R\$10.84	29 Jul 2014
ENERGIAS DO BRASIL	ENBR3.SA	Buy	N/A	R\$10.68	29 Jul 2014
ENEVA	ENEV3.SA	Neutral	N/A	R\$1.10	29 Jul 2014
Equatorial Energia	EQTL3.SA	Sell	N/A	R\$25.80	29 Jul 2014
IENOVA	IENOV.MX	Neutral	N/A	P74.92	29 Jul 2014
LIGHT	LIGT3.SA	Neutral	N/A	R\$21.72	29 Jul 2014
SABESP ¹⁶	SBSP3.SA	Sell	N/A	R\$21.04	29 Jul 2014
Tractebel Energia	TBLE3.SA	Sell	N/A	R\$35.35	29 Jul 2014
Transmissão Paulista	TRPL4.SA	Buy	N/A	R\$29.08	29 Jul 2014

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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