

## Brazilian Utilities

### Discos: Less attractive than Gencos or Transcos

#### Equities

Latin America  
Utilities

#### 4<sup>th</sup> Tariff reset cycle: under discussion now for implementation as early as 2015

We discussed yesterday in Brasilia the 4th tariff cycle, impacting Enersis' Coelce (April), Eletropaulo (July), Equatorial's Celpa and Iberdrola's Elektro (Aug), CPFL's Piratininga and Energias' Bandeirante (Oct). Key issue is that the methodology is changing vs. the 3rd cycle shortly before its implementation, and for worse: lower returns and, more importantly, increasing risks that future + past investments will yield nil returns and that efficiency gains will be fully captured by end users via lower tariffs. We remain sceptical that Discos' returns will improve significantly, especially under a scenario of low GDP growth, as we anticipate limited-only improvements to the current methodology.

#### Watch for changes: WACC, RAB, O&M fee for depreciated assets, opex trends

In a nutshell: (i) the 7.16% proposed WACC or even the 7.5% we carry in our models are too low vs fixed income yields and unattractive when compared w/ lower-risk Genco or Transco returns; regulatory returns in Brazil are coming down and are lower than those of Andean countries despite increasingly higher fixed income returns /macro & regulatory risks in Brazil (see Figures 1 and 2); (ii) cos argued the price database used for the Regulatory Asset Base (RAB) has several inconsistencies, incentivizing cos. to adopt more expensive/less efficient projects that lead to higher end-user tariffs; (iii) still nil remuneration for special obligations (assets built w/ customers' resources) or for fully-depreciated assets that are however still operational-these represent >50% of total assets for 80% of Bz discos and methodology incentivizes cos to replace them rather than extend their useful life; (iv) loss reduction and opex efficiency targets seem very aggressive; (v) earnings predictability remains very low.

#### LatAm capex is rising; return outlook is overall solid but in selected countries

LatAm remains attractive in our view (click here for UBS's global capex note or here for LatAm contribution to European utilities earnings growth), but mostly due to solid return outlook for Andeans and Mexico (click here for our IEnova note).

#### Valuation: still cautious on Brazilian utilities

We favour CTEEP, AES Tiete ON, Energias (the latter on undervalued genco assets)

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**Figure 1: Brazilian Discos: regulatory WACC proposal for the 4<sup>th</sup> tariff reset cycle vs. current and past WACCs**

	1st cycle 2004-07	2nd cycle 2007-10	3rd cycle 2011-14	4th cycle proposal 2015-18	Comments
Equity	50.0%	42.8%	45.0%	47.0%	Should be >60%, as underscored by near-bankruptcy w/ongoing hydrological and Govt's failure to buy cheap energy contracts on behalf of Discos or prevent delayed start-up of several Genco projects. ANEEL used gross (as opposed to net) debt.
Debt	50.0%	57.2%	55.0%	53.0%	
Risk Free Rate (Rf)	6.00%	5.30%	4.87%	5.78%	ANEEL used median (not avg) for Bz country risk, ignoring standard deviations which do lead to higher business risks.
Equity Risk Premium (ERP)	7.80%	6.10%	5.82%	5.01%	UBS uses the same 5%.
Leveraged Beta	26.40%	77.20%	74.00%	66.64%	5-year Beta is much lower than 1 or 2-yr Beta as does not capture new environment post-MP579. ANEEL reduced sample of USA discos to 14 from 29; the same 14 were used for the Beta calculation of lower-risk Transmission.
Sovereign Risk Premium	4.10%	4.90%	4.25%	2.80%	UBS uses 7% in US\$ for "Rf + Sovereign Risk Premium". Bz risk free rate of 6.02% in real R\$ as opposed to 7.12% shown by IPCA coupon bonds.
FX Risk Premium	2.00%	1.80%	0.00%	Included in Beta	Not nil as seen by recent volatility, and not included in Beta calculation in our view.
Regulatory Risk Premium	3.30%	Included in Beta	0.00%	Included in Beta	Not nil, higher than previously as underscored by MP579 and higher govt intervention. Beta was underestimated (Beta came down relative to 3rd cycle as sample was USA cos).
Credit Risk Premium	3.70%	3.00%	2.14%	3.28%	
<b>Cost of Equity (nominal)</b>	<b>17.50%</b>	<b>16.70%</b>	<b>13.43%</b>	<b>11.92%</b>	<b>Should increase relative to 3rd cycle given higher business risks; is very similar to cost of debt.</b>
<b>Cost of Equity (real)</b>	<b>14.75%</b>	<b>13.74%</b>	<b>10.72%</b>	<b>9.28%</b>	<b>UBS using ANEEL's numbers. Similar to that of Transcos.</b>
Cost of Debt (nominal)	15.80%	15.00%	11.26%	11.86%	Average, not marginal; includes cheap BNDES loans.
Cost of Debt (real)	13.09%	12.09%	8.60%	9.22%	With cost of debt lower than cost of equity, cos are incentivized to work w/nil equity...
Tax Rate	34%	34%	34%	34%	
U.S. Inflation	2.40%	2.60%	2.45%	2.41%	Past inflation, not forecasted inflation.
Nominal WACC	13.90%	12.80%	10.13%	9.75%	
<b>After-Tax Real WACC</b>	<b>11.30%</b>	<b>9.90%</b>	<b>7.50%</b>	<b>7.16%</b>	<b>Seems low versus 7.16% for Bz Gencos (O&amp;M-based tariff) and 6.64% for Bz Transcos. Note that ANEEL insists on capturing fiscal benefits of cos located in developing regions despite injunction preventing so.</b>
<b>Before Tax Real WACC</b>	<b>17.10%</b>	<b>15.10%</b>	<b>11.36%</b>	<b>10.85%</b>	<b>Compares w/ 10-12% for Chile and Peru (stable for 3-2 decades).</b>

Source: ANEEL; UBS

**Figure 2: Brazil reg. returns vs. selected Latam countries**

Country	Before-tax real regulatory return	Comment
Colombia	13.9%	Set every 5 years.
Peru	12.0%	Set by law since 1992.
Brazil 3rd cycle	11.4%	Set every 4 years in average, depending on each disco.
Brazil 4rd cycle	10.9%	Set every 4 years in average, depending on each disco.
Chile	10.0%	Set by law since 1982.

Source: UBS

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

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<b>CEMIG<sup>16</sup></b>	CMIG4.SA	Sell	N/A	R\$18.91	28 Aug 2014
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<b>COPEL<sup>16</sup></b>	CPL6.SA	Neutral	N/A	R\$39.20	28 Aug 2014
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<b>LIGHT</b>	LIGT3.SA	Neutral	N/A	R\$24.15	28 Aug 2014
<b>SABESP<sup>16</sup></b>	SBSP3.SA	Sell	N/A	R\$21.08	28 Aug 2014
<b>Tractebel Energia</b>	TBLE3.SA	Sell	N/A	R\$37.57	28 Aug 2014
<b>Transmissão Paulista</b>	TRPL4.SA	Buy	N/A	R\$32.50	28 Aug 2014

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

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