FITCH AFFIRMS EDP AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-Barcelona/London-31 October 2016: Fitch Ratings has affirmed EDP - Energias de Portugal S.A.'s (EDP) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB-', Short-Term IDR at 'F3' and hybrid securities at 'BB'. The Outlook on the IDR is Stable. A full list of rating actions is at the end of this commentary.

The affirmation reflects EDP's leading position in Portugal, the supportive and fast-growing renewables business and the moderate exposure to merchant risk. It also factors in some uncertainties coming from Brazil and the shift to a liberalised market in 2017 for the capacity managed under long-term contracts in Portugal. Fitch's forecasts result in average funds from operations (FFO) adjusted net leverage of 4.8x and FFO interest coverage of 4.5x for 2016-2020, both within the guidelines for the 'BBB-' rating, reaching the positive guidelines by 2020. The updated business plan confirms the management's intention to reduce leverage and preserve the largely regulated and quasi-regulated business mix.

KEY RATING DRIVERS

Supportive Business Plan to 2020

The management expects to achieve moderate growth by 2020 (EBITDA CAGR of 3%), a function of increasing renewables and efficiency gains. The business plan foresees lower net capex and benefits from Portuguese regulatory receivables (RRs) sales and EUR1bn of asset disposals, largely from the execution of the China Three Gorges' (CTG) partnership, leaving room for reducing leverage and increasing returns to shareholders. The business plan confirms EDP's intention to pursue growth only in activities with medium to high visibility and to reduce leverage.

Net Debt Decrease

The positive trading and the large tariff deficit assets sales already materialised year-to-date support a substantial reduction in Fitch-adjusted net debt to around EUR15.5bn by end-2016 from EUR17bn in 2015. From 2017, we expect positive free cash flows (FCF), mainly deriving from declining RRs and a stricter capex policy, to be deployed towards debt reduction. FFO is projected to slightly increase with moderate EBITDA growth and reduced financial costs being largely offset by growing minorities' leakage and higher cash taxes due to RRs monetisation.

Moderate Net Capex

The business plan includes annual average capex of EUR1.4bn across the period 2016-20, net of the proceeds from asset rotation of EUR1.6bn across the plan (around 60% already achieved in 2016). In our view, the conclusion of the large hydro projects in Iberia leaves EDP with more flexibility over its investments, benefiting also from average time to EBITDA of less than two years. The group has a clear focus on onshore wind and the US, and will slowly reduce the weight of Iberia in its cash flows.

Shift to Merchant Largely Offset

From 2017, all Power Purchase Agreements (PPAs)/costs from the maintenance of the contractual balance (CMEC) plants in Portugal will be exposed to price and volume risk. Fitch assumes this move to be negative for the credit profile, but that it will be mitigated by the full integration with supply and new capacity in wind with PPAs and hydro. By 2020, the expected EBITDA share from liberalised activities will rise, according to Fitch's estimates, to 24% (from 9% in 2012), still below the average of its EU peers.

Declining Portuguese Regulatory Receivables

Fitch expects the declining trend of RRs started in 2015 to continue. The recent government proposal for a 1.2% nominal average tariff increase for 2017 is slightly below the committed increases between 1.5% and 2% in real terms. However, we see the gap offset by additional funding measures (eg. EUR140m wind farms injection). The reduction in RRs on EDP's balance sheet is key to support deleveraging from 2016 as a function of declining outstanding RRs in the system and management's decision of keep selling those assets. Any delay in the system's tariff deficit reduction would probably translate into a slower reduction in leverage.

Improved Operating Environment in Brazil
The end of a two-year drought has alleviated the issues linked to the hydro scarcity for electricity generation in Brazil. The government's structural measures have eased the financial impact on the companies and limited the downside risk in extremely dry years in the future. However, we still have concerns linked to a rising possibility of political interference in a weak macroeconomic scenario, increased delinquency due to higher energy tariffs, FX risk exposure and a decrease in electricity demand.

Exposure to Iberian Baseload Price Volatility
EDP's conventional generation portfolio in Iberia is large in hydro (54% of conventional generation fleet), and hence clean and profitable but also exposed to volatility related to weather and baseload price. The volatility is mitigated by the commissioning of new pumping hydro capacity with spreads between peak/off-peak prices persisting under lower average prices due to wind volatility, financial hedges, and the supportive platform of its customer base that it is now largely in the liberalised market.

DERIVATION SUMMARY
EDP's business risk profile has a lower share of purely regulated businesses, although it benefits from a higher share of long-term contracted or quasi-regulated businesses (largely renewables), than Southern European peers (eg, Iberdrola and Enel). In addition, it has higher leverage and larger leakage due to minorities within the group structure. All the above justifies the current two-notch differential from these peers. However, the 2016-2020 business plan focuses on regulated business and renewables with support mechanisms in strong economies, such as the US, and incorporates a substantial reduction in leverage, potentially narrowing the differential with its European peers by 2020.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- FY16 EBITDA at EUR3.75bn (excluding non-recurring items) and a 2% CAGR for 2016 to 2020, driven by wind and hydro organic growth and efficiency improvements.
- Average netted by asset-rotation-plan capex of EUR1.4bn per year for 2016-2020 and around EUR1bn of additional cash-in for disposals linked largely to CTG
- Increased dividend floor to EUR0.19 per share to be paid in 2017 and slight annual increase thereafter.
- Declining Portuguese RRs on balance sheet for 2016-2020, largely materialised in 2016. This implies EDP will continue with securitisation in Portugal at a pace of EUR0.5bn on average for 2017-2020. No new TD in Spain and Brazil.
- Brazilian real to depreciate against the euro by around 30% up to 2020. Stable euro/dollar.

RATING SENSITIVITIES
Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- FFO adjusted net leverage trending towards 4.5x and FFO interest coverage above 4.0x on a sustained basis, assuming no major changes in the activities' mix other than expected by Fitch.
- Sustained positive free cash flows, together with the consistent reduction in the tariff deficit in Portugal in line with expectations.
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO net adjusted leverage above 5.0x and FFO interest coverage below 3.5x over a sustained period.
- Adverse regulatory or fiscal changes in any of the core markets affecting the predictability of cash flows, including substantial delays in declining Portuguese tariff deficit outstanding debt.
- A substantial increase in operations in emerging markets with a higher business risk or a substantial shift in business mix towards unregulated activities, higher than expected by Fitch, could lead us to tighten the ratio guideline for the current rating.

LIQUIDITY
Strong Liquidity: As of end-June 2016, committed facilities plus cash on hand amounted to EUR5.6bn. This compares with remaining 2016 and 2017 debt maturities of EUR2.9bn. Fitch expects the company to generate positive free cash flow in the second half of 2016 driven by additional EUR1bn regulatory receivables sales. In addition, group cash has increased by around EUR200m following the net capital increase by EDP Brazil in July 2016. EDP's liquidity is sufficient to cover its refinancing needs over the next 24 months.
FULL LIST OF RATING ACTIONS

EDP - Energias de Portugal S.A.
- Long-term Issuer Default Rating (IDR) affirmed at 'BBB-', Stable Outlook
- short-term IDR affirmed at 'F3'
- senior unsecured rating affirmed at 'BBB-',
- subordinated rating affirmed at 'BB'.

EDP Finance B.V
- Long-term IDR affirmed at 'BBB-', Stable Outlook
- senior unsecured rating affirmed at 'BBB-',
- short-term IDR affirmed at 'F3'
Hidroelectrica del Cantabrico, S.A.
- Long-term IDR affirmed at 'BBB-', Stable Outlook
- short-term IDR affirmed at 'F3'.

Contact:
Principal Analyst
Antonio Totaro
Director
+39 02 879 087 297

Supervisory Analyst
Pilar Auguets
Director
+34 93 467 8747
Fitch Ratings Espana, S.A.U.
Paseo de Gracia, 85. 7th floor
08008 Barcelona

Committee Chair
Arkadiusz Wicik
Senior Director
+48 22 338 6286

Summary of Financial Statement Adjustments -
- Leases: Fitch has adjusted the debt by adding 6.4x of annual operating lease expenses.

- Adjustment for restricted/not available cash: Fitch adjusted available cash at end-2015 by deducting EUR38m to reflect cash held under project-finance structures with some restricted cash.

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
https://www.fitchratings.com/site/re/885629
Treatment and Notching of Hybrids in Non-Financial Corporate and REIT Credit Analysis (pub. 29 Feb 2016)
https://www.fitchratings.com/site/re/878264