Research Update:

# Brazilian Electric Utility CEMIG Outlook Revised To Positive On Stronger Credit Metrics; 'BB-' Ratings Affirmed

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## Rating Action Overview

- Companhia Energetica de Minas Gerais – CEMIG has been posting stronger credit metrics than we expected, thanks to solid operating performance and recent asset sales, which should help fund significant capital expenditure (capex).
- While R$35.6 billion in capex for 2024-2028 should lead to consistently negative free operating cash flow (FOCF) in the next few years, we could raise the ratings in the next 12-24 months if these investments bolster cash flow, further improving CEMIG's credit metrics.
- As a result, on Nov. 26, 2024, S&P Global Ratings revised the outlook on CEMIG and its operating subsidiaries, Cemig Distribuicao S.A. (CEMIG-D) and Cemig Geracao e Transmissao S.A. (CEMIG-GT), to positive from stable. We affirmed the 'BB-' global scale and 'brAA+' national scale issuer credit rating on CEMIG (or the group), as well as 'BB-' rating on CEMIG-GT's senior unsecured notes and the 'brAA+' rating on CEMIG-D's debentures.
- The positive outlook reflects our view that we could upgrade CEMIG and its subsidiaries in the next 12-24 months if the group's sizable investments boost cash generation and credit metrics, with debt to EBITDA of less than 3.5x and FFO to debt more than 20% in the medium term, despite consistently negative FOCF.

## Rating Action Rationale

**We could upgrade CEMIG if it improves cash generation while maintaining comfortable credit metrics.** For 2024-2028, CEMIG plans to invest roughly R$35.6 billion in its core businesses--especially distribution, but also generation, and transmission of energy--located mainly in the state of Minas Gerais. The annual capex averaging R$6.2 billion in the next five years (up from R$3.4 billion in 2022 and R$4.9 billion in 2023) should lead to an annual shortfall in FOCF of R$1.5 billion – R$2.7 billion in 2025-2027. Absent additional asset sales, the company would need to raise additional debt, which we expect to double from about R$12 billion in 2024 to roughly R$24 billion in 2027.

In our view, this poses execution risks, especially in 2026 when we expect investments to peak at R$7 billion and negative FOCF of about R$2.7 billion. Nevertheless, as long as the group sustains its favorable operating performance and as revenue from its investments materializes, we believe that CEMIG could lower its cash needs, allowing it to maintain its comfortable credit metrics. In this sense, the positive outlook on CEMIG reflects our view that we could upgrade it on the global and national scale to 'BB' and 'brAAA' if it reports only moderately negative FOCF in the next few years, while maintaining adjusted net debt to EBITDA at 3.0x-3.5x and FFO to debt above 20%.

**Operating performance is gradually improving.** CEMIG has been reporting stronger-than-expected credit metrics in the past two years, with debt to EBITDA of 2.5x-3.0x and FFO to debt averaging 30%, thanks to improved operating performance because of favorable tariff adjustments at its distribution business and high energy spreads at CEMIG-GT. The latter stems from power purchase agreement (PPA) prices that were negotiated at higher levels during the 2021 drought, and low energy purchase prices as a result of favorable hydrology. In 2024, the group received tariff adjustments above inflation (Brazil's Consumer Price Index as of October 2024 was 4.76%) for CEMIG-D and the transmission lines of CEMIG-GT of 7.32% and 5.2%, respectively, boosting our expectation of cash flow.

In addition, CEMIG completed in 2024 the sale of its 45% stake in Aliança Energia S.A. to Vale S.A. for R$2.7 billion. The proceeds will support the group's deleveraging, as it won't need to access capital markets in the very short term to fully amortize CEMIG-GT's $381 million outstanding international notes due December 2024. As a result, we expect CEMIG's adjusted net debt to EBITDA of about 2.5x and FFO to debt of 30% in 2024, and about 3.0x and 20%, respectively, in 2025 and 2026, considering that energy spreads will gradually normalize because of currently lower energy sales prices, basic interest rates are increasing again in Brazil, and because of CEMIG's sizable investments.

**The concession's expiration could pressure metrics in the medium term.** We expect CEMIG's debt to EBITDA and FFO to debt to deteriorate in 2027 and 2028 to 3.5x and 15%-20% (from 3.0x and 20%) because the concession for 1,780 megawatts (MW) of CEMIG-GT's installed capacity will expire in 2027 (for the Emborcação, Nova Ponte, and Sá Carvalho hydro plants). While CEMIG intends to renew it, the process also depends on the granting authority. If CEMIG is unable to renew the concession, which would also require renewal fees, EBITDA would shrink by about R$900 million, and the group would have to buy additional energy in the market to honor its PPAs. This could increase the group's exposure to electricity prices in the long term, in our view.

**The privatization process is still uncertain.** On Nov. 14, 2024, the state of Minas Gerais notified CEMIG that it proposed a bill for its privatization. Unless a proposed change to the state constitution is accepted, the privatization would require approval from a popular referendum, which is unlikely given the public's low acceptance of the matter. Finally, it would also depend on legislative approval, which is uncertain. We'll monitor any new development and reassess the implications for CEMIG, especially in terms of governance in case it is privatized.

# Outlook

The positive outlook reflects our view that we could upgrade CEMIG and its subsidiaries in the next 12-24 months if its sizable investments bolster cash generation, which would narrow its FOCF shortfall, while maintaining debt to EBITDA at less than 3.5x and FFO to debt of more than 20% in the medium term.

## Downside scenario

We could revise the outlook back to stable or even lower the ratings on CEMIG and its subsidiaries if the group's credit metrics worsen, with debt to EBITDA consistently above 4.5x, FFO to debt below 13%, and negative FOCF. In our view, cash flow could worsen due to consistently higher energy costs if hydrological conditions weaken throughout 2025. Weaker credit metrics could also result from much higher-than-expected investments or a large debt-financed acquisition without the offsetting cash flow. We could also downgrade CEMIG if its liquidity worsens either because of refinancing challenges or due to tight covenant headroom.

## Upside scenario

We could upgrade CEMIG to 'BB' and to 'brAAA' if it reports a narrower FOCF shortfall in the next few years, especially in 2026, while maintaining strong credit metrics. Specifically, we would need to see FFO to debt above 20% and debt to EBITDA below 3.5x on a consistent basis, provided that the state of Minas Gerais continues to refrain from interfering in the group's operations. Credit metrics could strengthen, for instance, if CEMIG generates higher cash from its investments or if it continues selling its assets to prepay the outstanding debt.

# Company Description

CEMIG is one of the largest utility groups in Brazil. It operates in the electricity and gas distribution (about 50% of EBITDA), generation and energy trading (35%-40%), and transmission (9%) segments. The group is responsible for distributing electricity to its roughly 9.3 million clients in the state of Minas Gerais, which is one of the most densely populated states in Brazil. In addition, CEMIG has 4.5 gigawatts (GW) of installed capacity across 61 power plants and benefits from 5,060 km of power transmission lines, including stakes in equity method investments. CEMIG is controlled by the state of Minas Gerais, which has 50.97% of voting shares and 17.04% of total shares.

# Our Base-Case Scenario

## Assumptions

- Brazil's GDP to grow 3.1% in 2024, 1.9% in 2025, and 2.1% in 2026, in line with "Economic Outlook Emerging Markets Q1 2025: Trade Uncertainty Threatens Growth", Nov. 26, 2024. Nevertheless, we expect CEMIG's energy consumption at the distribution business to grow below the GDP rate, at about 1.5% in 2024 and 0%-1% afterward as a result of the migration of captive clients to the distributed generation segment and free market.
- In 2024, we incorporate the rate adjustment of 7.32% for CEMIG-D, which has been approved by Brazil's electricity regulator. We forecast rates increasing in line with inflation of previous year--4.3% in 2025 and 4.2% in 2026.

- The average cost of energy in the distribution business will be R$295 per megawatt hour (MWh) and increasing in line with inflation starting in 2025. We assume favorable hydrological conditions in 2025 as a result of the recovery of the reservoir capacity during the wet season in 2024-2025.
- A global scaling factor, which determines the group's level of energy delivery, of roughly 85% starting in 2024.
- The average sale price of energy at R$175/MWh - R$180/MWh in 2024, R$170 - R$175 in 2025, and around R$180 in 2026, considering the existing contracts. We assume average energy purchase costs of R$90/MWh - R$100/MWh starting in 2024, reflecting still favorable hydrological conditions.
- RAP of CEMIG's transmission lines of about R$1.36 billion in the 2024-2025 cycle and increasing in line with inflation starting in 2025. New projects and the modernization and reinforcement of the transmission lines should support higher RAP going forward. We expect net revenue in the segment of about R$1.20 billion in 2024, R$1.26 billion in 2025, and R$1.3 billion in 2026.
- Annual investments of about R$5.8 billion in 2024, R$5.7 billion in 2025, and peaking at R$7.0 billion in 2026, assuming 90% of the group's budget plan, because the capex execution has historically been below target.
- The basic interest rate at the end of the year of 11.75% in 2024, 11.25% in 2025, and 9.5% in 2026, affecting the group's interest expenses.
- Although the group plans additional minority stakes divestments, we don't incorporate them, given the uncertain timing. We incorporate the sale of noncore equity investments that were completed in 2024, such as Aliança Energia (R$2.7 billion) and 15 small power plants (R$100.5 million).
- The payment of CEMIG-GT's outstanding $381 million notes in December 2024.
- Dividends received from affiliates of R$380 million - R$430 million in the next few years.
- The dividend payout of 50% of the previous year's net income starting in 2024, totaling R$2.7 billion this year.
- Our adjusted debt figures include pension-related liabilities (about R$5.4 billion) and financial guarantees provided to Belo Monte, CEMIG's equity affiliate, for R$3.3 billion.

## Key metrics

Companhia Energética de Minas Gerais – Cemig*

| Mil. R$ | 2022a | 2023a | 2024e | 2025f | 2026f |
|---|---|---|---|---|---|
| Revenue | 28,392 | 30,089 | 32,000-33,000 | 32,500-33,500 | 34,000-35,000 |
| EBITDA | 4,995 | 6,240 | 7,000-7,500 | 6,300-6,800 | 7,300-7,800 |
| Funds from operations (FFO) | 3,277 | 4,608 | 5,000-5,500 | 4,000-4,500 | 4,800-5,300 |
| Capital expenditure | 3,405 | 4,942 | ~5,800 | ~5,800 | ~7,000 |
| Free operating cash flow (FOCF) | 3,208 | 1,702 | (800)-(600) | (1,650) -(1,450) | (2,850) - (2,650) |
| Debt to EBITDA (x) | 3.5 | 2.7 | 2.0-2.5 | ~3.0 | ~3.0 |
| FFO to debt (%) | 18.5 | 27.0 | ~30 | ~20 | ~20 |

| | | | | | |
|---|---|---|---|---|---|
| FOCF to debt (%) | 18.1 | 10.0 | (7)-(2) | (10)-(5) | (13)-(7) |

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

# Liquidity

We expect CEMIG's sources of liquidity to surpass uses by more than 10% in the next 12 months. CEMIG's cash position was healthy at approximately R$6.6 billion as of Sept. 30, 2024, considering the proceeds from asset sales and the new debentures of R$2.5 billion issued by CEMIG-D. As the group refinanced CEMIG-GT's dollar-denominated bonds in stages in the past years, and considering the group's sizable cash position, we don't have concerns about the December 2024 maturity of the outstanding $381 million notes. Moreover, the group's capex will increase the financing needs in the next few years, but we believe CEMIG's improved operating and financial performance supports its access to debt and capital markets, enabling the refinancing and placing new debt to fund its investments. This is evidenced by the recent issuances of debentures at CEMIG-D for R$4.5 billion in March and September 2024. We believe CEMIG's cash generation will also support the continuity of its dividend distribution of 50% of the previous year's net income going forward, in line with its bylaws.

## Principal liquidity sources

- Cash and cash equivalents of R$6.6 billion as of Sept. 30, 2024; and
- Projected FFO of R$4.0 billion - R$4.5 billion in the next 12 months.

## Principal liquidity uses

- Short-term debt maturities of about R$4.8 billion as of Sept. 30, 2024;
- Maintenance capex of about R$2.3 billion in the next 12 months;
- Seasonal working capital needs of about R$500 million annually; and
- Dividend payment of R$1.6 billion - R$1.8 billion in the next 12 months, assuming a 50% dividend payout.

# Covenants

The covenants include a consolidated maximum debt to EBITDA threshold of 2.5x at CEMIG-GT, which is relative to the international notes, and will increase to 3.5x after their full amortization in December 2024. For CEMIG-D, the covenant is 3.5x until June 2029 and 4.0x afterward, and on a consolidated basis, the threshold is 3.0x until June 2026, 3.5x from December 2026 to June 2029, and 4.0x afterward. The covenants are measured semiannually. We expect the group to comply with the required thresholds for the next two years, with comfortable cushion in the next three years. The covenant's calculation methodology is different from credit metrics we consider, because financial metrics related to debt include the deficit at Forluz, the employee pension plan, carrying liabilities related to put options, and exclude the fair value of hedges and cash equivalents, while EBITDA includes the financial assets related to the distribution concession.

# Issue Ratings--Subordination Risk Analysis

## Capital structure

We rate CEMIG-GT's $381 million senior unsecured notes due December 2024. As of Sept. 30, 2024, the subsidiary reported roughly R$3.2 billion in gross debt. We also rate CEMIG-D's seventh debentures due 2026 with a balance of approximately R$2.04 billion at the end of the third quarter of 2024. The distributor reported approximately R$9.9 billion in debt in the same period.

## Analytical conclusions

Given that the bulk of CEMIG-GT's debt is at the holding level and the company has a limited amount of priority debt in its capital structure, we rate the bonds 'BB-', the same as the issuer credit rating on CEMIG-GT. All of CEMIG-D's debt is at its own level, and it doesn't have subsidiaries. As a result, we rate this debt at the same level as the subsidiary, 'brAA+'.

# Rating Component Scores

**Rating Component Scores**

| Component | |
|---|---|
| Foreign currency issuer credit rating | BB-/POSITIVE/-- |
| Local currency issuer credit rating | BB-/POSITIVE/-- |
| Business risk | 3 - Satisfactory |
| Country risk | 4 - Moderately High Risk |
| Industry risk | 2 - Low Risk |
| Competitive position | 3 - Satisfactory |
| Financial risk | 5 - Aggressive |
| Cash flow/leverage | 5 - Aggressive |
| Anchor | bb |
| Diversification/portfolio effect | 3 - Neutral/Undiversified |
| Capital structure | Neutral |
| Financial policy | Neutral |
| Liquidity | Adequate |
| Management and governance | Moderately Negative |
| Comparable rating analysis | Neutral |
| Stand-alone credit profile | bb- |

# Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024

- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- 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
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

# Ratings List

| **Ratings list** | | |
|---|---|---|
| **Ratings Affirmed; Outlook Action** | | |
| | **To** | **From** |
| **Companhia Energetica de Minas Gerais - CEMIG** | | |
| **Cemig Distribuicao S.A.** | | |
| **Cemig Geracao e Transmissao S.A.** | | |
| Issuer Credit Rating | BB-/Positive/-- | BB-/Stable/-- |
| Foreign Currency | BB-/Positive/-- | BB-/Stable/-- |
| Brazil National Scale | brAA+/Positive/-- | brAA+/Stable/-- |
| **Ratings Affirmed** | | |
| **Cemig Distribuicao S.A.** | | |
| Senior Unsecured | brAA+ | |
| **Cemig Geracao e Transmissao S.A.** | | |
| Senior Unsecured | 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.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.