

Brazil utilities sector analysis!

I'll start researching Brazil by looking at the sector I know best, utilities. We'll go through all the stocks in the environment to find their current risk reward. Let's start.

Figure 1 Stocks to look at from the Brazilian utility sector

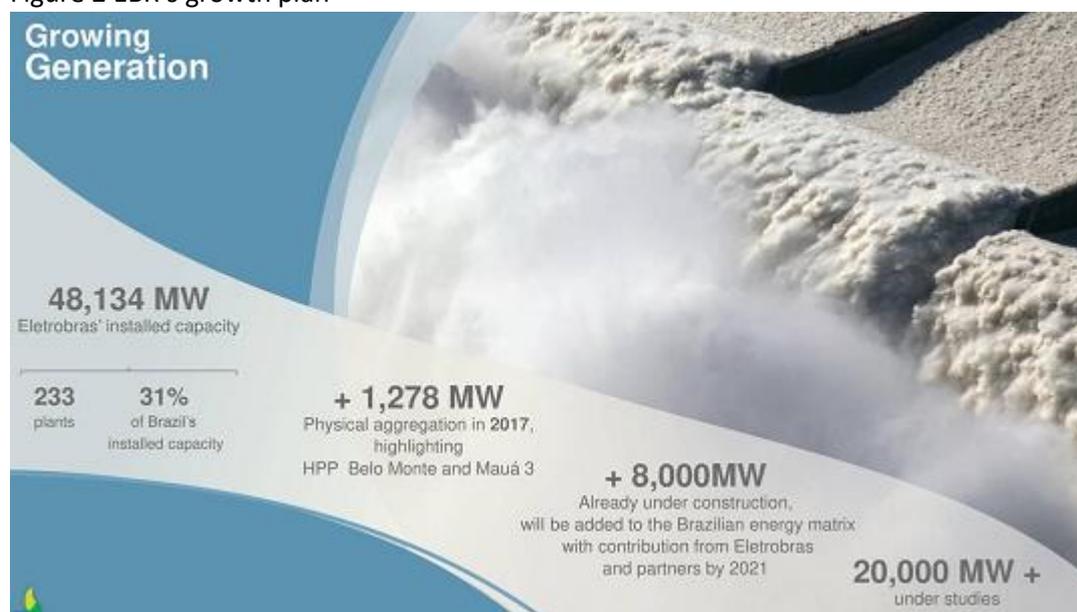
Centrais Eletricas Brasileiras	EBR	NYSE	Electricity -		0.4	Suspende
Comp. Paranaense de Energia-COPEL	ELP	NYSE	Electricity	5.3	0.38	Cheap aga
Companhia Energetica de Minas Gerais-CEMIG	CIG	NYSE	Electricity	6.38	0.56	COMPARE
CPFL Energia	CPL	NYSE	Electricity	13.81	2	COMPARE
SABESP	SBS	NYSE	Gas,H2O&I	6.47	0.87	utility che
Ultrapar	UGP	NYSE	Gas,H2O&I	20.33	2.84	utility che
AES Tiete Energia	AESTY	Electricity				
Comp. Energetica de Sao Paulo-CESP	CSQSY	Electricity				
Duke Energy	DEIWY	Electricity				
Duke Energy - Pref	DEIPY	Electricity				
ENEVA	ENEVY	Electricity				
Engie Brasil Energia S.A.	EGIEY	Electricity				
Paulista	CTPTY	Electricity				
Weg	WEGZY	Electron.&ElectricEq				

Source: Author's data

ELECTROBRAS

Centrais Electricas Brasileiras (NYSE: EBR) has 31% of Brazil's installed electric production capacity and therefore it is a must watch company when investigating the sector. It has 48 GW in capacity and it plans to add another 8 GW by 2021 with another 20GW under studies.

Figure 2 EBR's growth plan



Source: [EBR](#)

The key factors with EBR are the following:

- High debt levels (company's and country's debt rating)

- Privatization issues
- Profitability
- Divestitures and investments
- Value of the assets?

Privatization issues

During the beginning of 2018, EBR was likely to be privatized where the [government](#) was expecting around \$3.6 billion in revenue for its share.

The Eletrobras privatization deal [includes](#):

- Renewed 30-year concessions on plants
- A golden government share
- Max 10% voting power for private shareholder
- Privatization through issue of new shares and secondary government placement

However, things haven't been going as planned. As we know the political environment isn't stable and changing ministers [delay](#) the privatization process. As the elections are in October and there have been delays, it is unlikely that congress will be able to vote for the [privatization](#) bill before the elections. The latest blow came in June when the Labor [court suspended](#) the privatization process requesting a study on the privatization's impact on the workers through the sale of 6 subsidiaries. All of this means the privatization will not happen during 2019 as it was expected.

However, if I look at the plans of those running for office, the two most likely to win, Bolsonaro and Silva, are in favor of privatization.

Figure 3 The Brazilian political outlook on privatization



Source: [BNP](#)

We could conclude that there is a good chance that the company will be privatized somewhere in 2020 which is two years from now. What will be the way it will be privatized is anybody's guess.

As the privatization hopes faded, shares sunk.

Figure 4 EBR's stock price went up on privatization hopes and consequently down

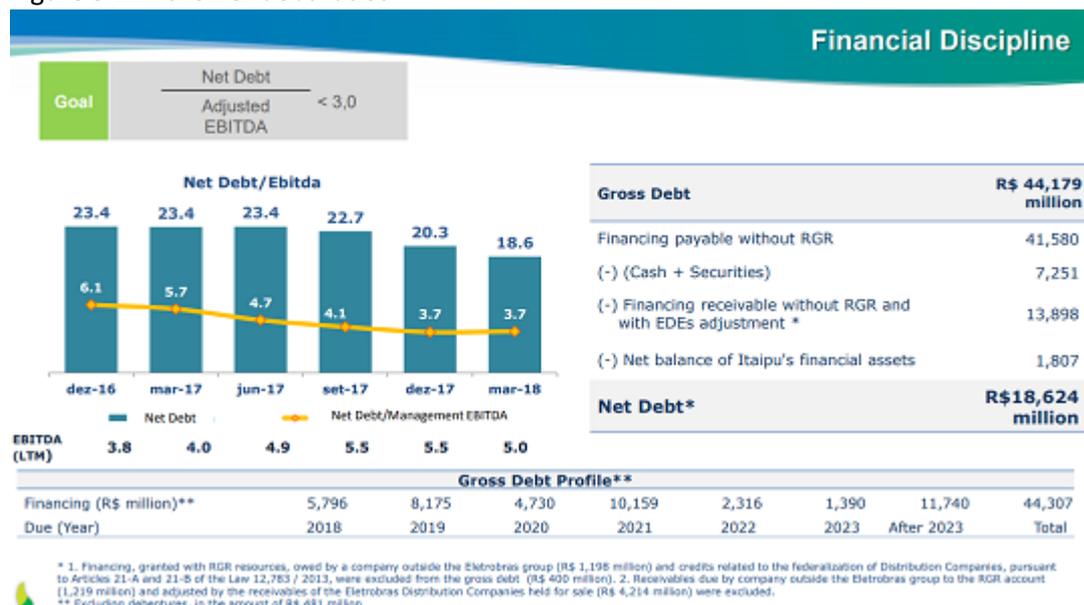


Source: [CNN money](http://www.cnn.com)

High debt

The management's focus has been to lower its debt to EBTIDA levels and it is going better.

Figure 5 EBR's lower debt ratios



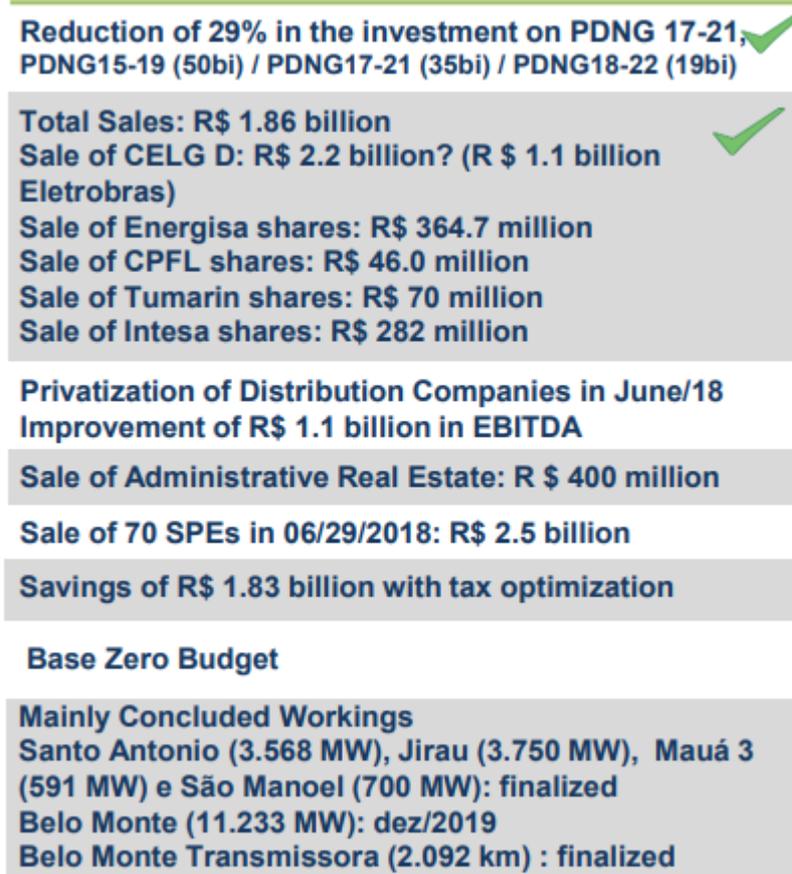
Source: [EBR](http://www.ebr.com.br)

The gross debt is R\$ 44 billion or about \$12 billion. The gross debt refinancing profile should be manageable if nothing terrible happens. One of the way debt will be lowered is through divestitures.

Divestitures and investments

The debt repayment might become easier from the planned divestitures.

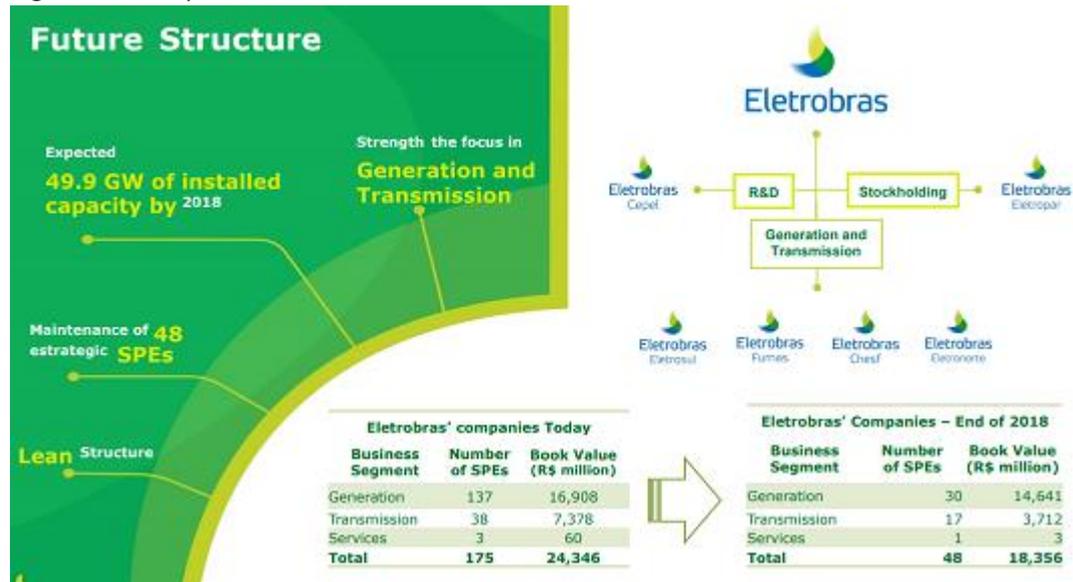
Figure 6 EBR's planned divestitures and investments



Source: [EBR](#)

The sales are expected to bring R\$ 5 billion over the next few years. The company is going to be slimmer and hopefully leaner.

Figure 7 EBR's plan



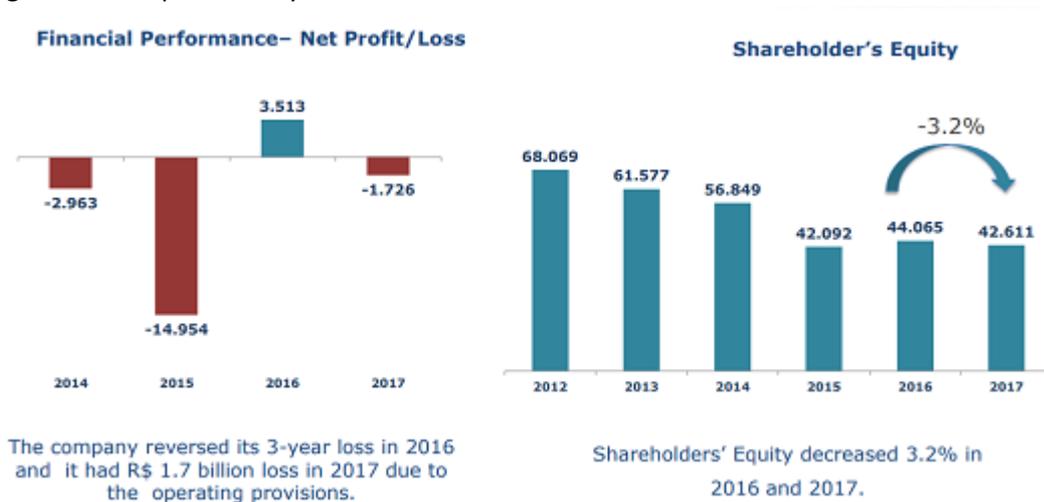
Source: [EBR](#)

On top of that, expected savings from financial discipline activities are expected to be around R\$ 3 billion but let's dig into operations to see where this could go.

Profitability

The company hasn't really been profitable since 2012 when the government lowered electricity prices.

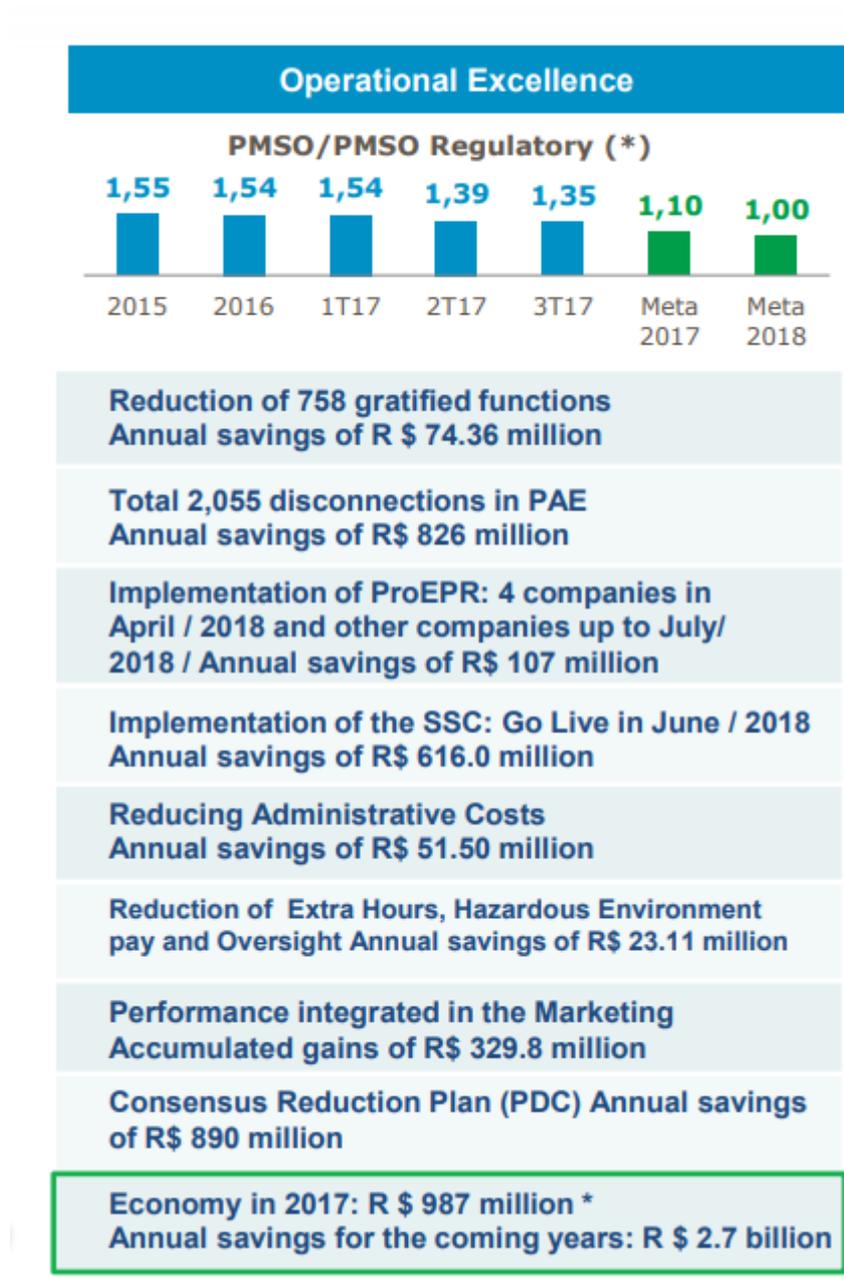
Figure 8 EBR's profitability



Source: [EBR](#)

The management expects to save R\$3 billion from financing and about \$2.7 billion per year from operational efficiency.

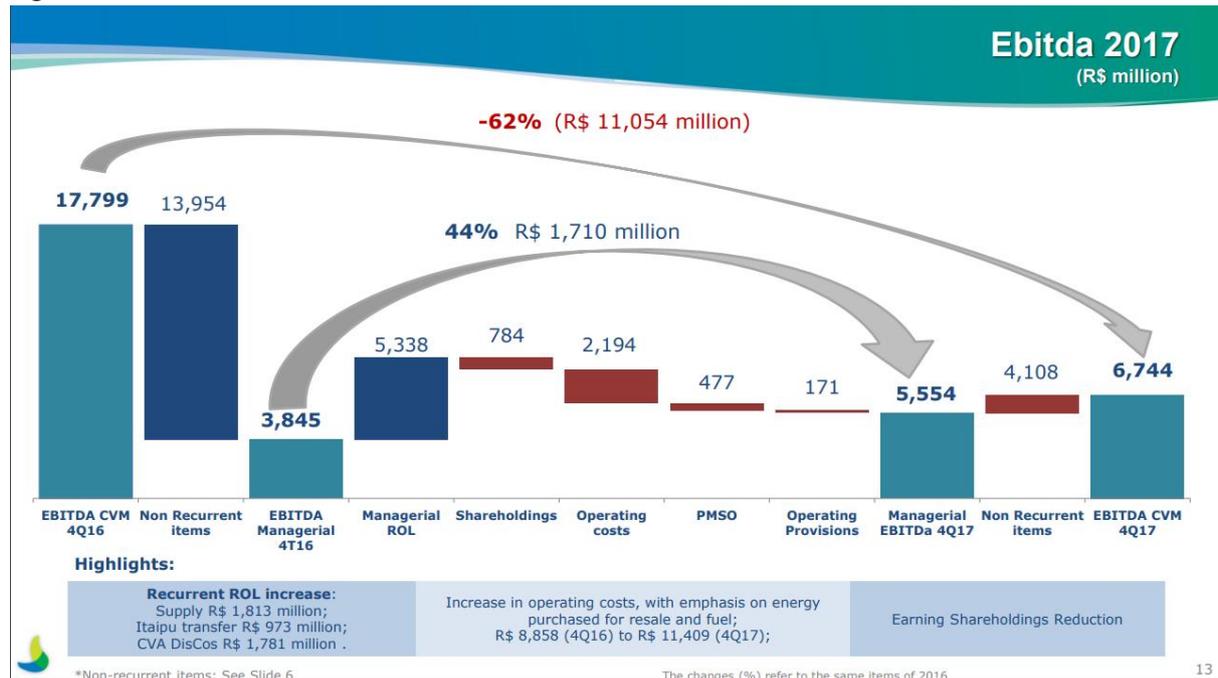
Figure 9 EBR's operational efficiency improvements



Source: [EBR](#)

Adjusting for the non-recurring items that will go away when the company stabilizes, hopefully, might significantly improve the financials and privatization price where we could see even a dividend in the future.

Figure 10 EBR's EBITDA



Source: [EBR](#)

As the net margins are tight, any kind of improvement might significantly affect the bottom line.

Figure 11 EBR's financials

Selected Consolidated Statements of Profit and Loss Data

	For the year ended December 31,				
	2017	2016(1)	2015(1)	2014	2013
	(R\$ thousands)				
Net operating revenue	37,876,024(2)	60,316,003(2)	32,180,843	30,137,807	23,835,644
Operating expenses / costs	(35,575,297)	(47,408,065)	(42,630,214)	(33,786,137)	(29,215,079)
Gain on sale of subsidiary	1,524,687	—	—	—	—
Investigation Findings	—	—	(15,996)	(195,127)	—
Financial result	(5,193,296)	(3,930,724)	(1,273,103)	694,625	376,684
Result/(loss) before participation in associates and other investments	(1,367,882)	8,977,214	(11,738,470)	(3,148,832)	(5,002,751)
Result of participation in associates and other investments	1,167,484	3,205,511	531,446	(1,308,304)	177,768
Income/(loss) before effects of Law No. 12,783	(200,398)	12,182,725	(11,207,024)	(4,457,135)	(4,824,983)
Income/(loss) before income tax and social contribution	(200,398)	12,182,725	(11,207,024)	(4,457,135)	(4,824,983)
Income tax and Social Contribution	(1,525,293)	(8,510,819)	(710,112)	(1,700,518)	(1,366,678)
Net income (loss) for the year	(1,725,691)	3,671,906	(11,917,136)	(6,157,653)	(6,191,661)
Attributable to controlling shareholders	(1,763,805)	3,584,529	(11,405,085)	(6,226,206)	(6,186,949)
Attributable to non-controlling shareholders	38,114	87,377	(512,051)	68,553	(4,712)
Net Income (loss) of the year per share (Basic)	(1.30)	2.53	(8.43)	(4.60)	(4.57)
Net Income (loss) of the year per share (Diluted)	(1.30)	2.50	(8.43)	(4.60)	(4.57)

Source: [20-F](#)

If they could improve the financials by R\$ 3 billion per year, we could see profits of R\$2 per share and perhaps even dividends. At current currency valuations this would translate in an EPS of \$0.5 per share.

For such a company I think, the price to buy at a margin of safety from a financial stand point is \$2.5.

Net income might be higher from time to time, but on R\$40 billion in revenue a healthy net margin would be 10% which is \$4 billion. Let's stick to R\$3 billion to be conservative.

Another interesting development might be the currency which is something to keep in mind. If the real appreciates to R\$3 for one U.S. dollar, the profitability suddenly increases to \$1 per share and at a healthy valuation of 10 we have a \$10 stock. A nice risk reward now, but let's first compare it to others in the sector and before ending let me share with you my view on the assets.

EBR's value

Do you know where nowhere is? Well, EBR's assets are in the middle of it.

I am not going to look at the book value of their assets because one is the book value and something different is the actual value. A lot of EBR's investments haven't been made with economic profitability in mind as it is a government owned company.

Figure 12 EBR's transmission assets



Source: [EBR](#)

71,754 km of transmission lines might sound impressive but it also means those have to be maintained across the country, at a higher cost. Therefore, let's stick to profitability as a key measure of value.