Nebraska Capital - Ninth Investment Report – April, 2019

To remind you, in these Investment Reports we cover developments with our investments, especially our main holdings, as well as other topics we might find interesting to share with you. In this edition, we write about Equatorial's acquisition of two distribution companies, in privatization auctions.

Equatorial (13% of the fund):

In December, 2016, we wrote a report about Equatorial's successful participation in an auction for greenfield transmission lines. At that time, both investors and businessmen in general, were deeply scared with Brazil's economy, leading to an auction with unprecedented high prospective returns on invested capital, as well as favorable contractual conditions. Now, we come back to report on Equatorial's acquisition of two of the six money-losing distribution companies that Eletrobrás (the federal government's electricity holding) managed to auction-off during 2018, a feat for which the government and the holding's management deserve praises, especially given all the hurdles that had to be cleared. With all of its legal constraints, it was impossible for Eletrobrás to operate those companies well for their clients and without losing money. (In previous reports we have written at length about regulation and "indirect competition" in the distribution business in Brazil, we will spare you repetition.)

In 2018, however, the business mood was much better than in late 2016, and especially so for electricity assets. During the year, transmission projects were often auctioned off to winners offering higher than 40% discounts on allowed annual revenues, whereas Equatorial offered 12% on average in 2016. Perhaps even more tellingly, in the first semester, an amazing bidding war between Neoenergia (controlled by the Spanish Iberdrola) and the Italian Enel for the control of Eletropaulo (a troubled distribution company, with challenging liabilities, operating in the city of São Paulo) pushed the shares of the acquired company from less than R$15.00 to more than R$45.00 (due to the tag along). We are grateful Equatorial sat on the sidelines while all of this was going on.

As we have often said, Equatorial's strength emanates from its human capital. Besides Equatorial, just two other local companies bid on Eletrobrás's distribution assets: Energisa, a holding bearing some similarities to Equatorial, and Oliveira Energia, which operates power plants in regions not linked to the national grid. This apparent lack of interest hides the fact that many funds and foreign electric holdings analyzed the companies being sold, all of which require difficult turnarounds. This managerial challenge likely scared these parties away, not only because operating distribution companies well (especially in poor regions) is very difficult in Brazil (for reasons we covered in past reports, such as electricity theft and customer defaults), but also because qualified personnel to do so is scarce.

Equatorial submitted bids for just two of the six assets. Even though it had interest in the others (especially for the big one in the state of Amazonas), it, conservatively, opted not to run a considerable legal risk. These four companies source a relevant part of their electricity from local power plants that run on diesel, an extremely expensive source of electricity. As regulation requires distribution companies to pay the bill for electricity losses above a given target, and as these companies are operating way above their targets, this potential bill, even if for a short period of time, could make these companies unviable from an economic perspective. The government tried to address this issue with a law (spreading the burden amid all electricity consumers in the country) for many months, but the usual mess amid lawmakers impaired it and the auctions proceeded without it or, in the case of Amazonas (which is certainly unviable without it), relying on a "Provisional Measure" (a weaker, temporary law issued by the Executive branch of the government).

Equatorial bid alone and got the two assets in the Northeast region, where it already owned Cemar, which sits, arguably, amid the top-five distribution companies in Brazil. The auctions were designed so that the winner would make a symbolic payment to Eletrobrás, inject a pre-defined amount of equity into the acquired company, and assume all of its outstanding liabilities. The bids would represent a discount to (a) the forgiveness of part of the assumed debt, (b) a rate surcharge for one regulatory cycle (five years), and (c) a larger target for electricity losses for the same period.

On July 26, in the first auction, Equatorial bid a 119% discount for Cepisa, the distribution company of the state of Piauí (neighbor to Cemar's state of Maranhão), only to find out later that it was bidding alone. The bid, however, is not as crazy as the 119% figure suggests at a first glance. Equatorial knows what it can do with this asset in operational terms (given the area's similarities to Cemar's), so that foregoing items (b) and (c) above is manageable; on item (a), Equatorial got no discount on R$844MM of debt, this amount however, bears interest fixed at a very low 5% nominal rate and amortizes between 2023 and 2048 - it has an economic value, therefore, way below its face value. And, as for the 19% of the 119%, its only effect was to augment the amount Equatorial paid upfront to Eletrobrás for the 89.9% equity stake it initially acquired in the auction; for each 1% offered, the buyer would pay R$5MM, so R$95MM was paid in this case - not negligible, but manageable from an Enterprise Value perspective (see the table below to get a picture of this, as well as item (a), in relation to EV).

And, as the lights were being shut down for the year, on December 28, Equatorial won the auction for Ceal, which operates in the nearby state of Alagoas, with a 0% discount bid. This auction had been delayed for months due to a trial dispute between the state and federal governments, with the former claiming to have economic rights (it once owned the company). Initially, Equatorial also got an 89.9% stake, the remaining (as in the case of Cepisa) will be offered to employees, with Equatorial taking what is left afterwards. In both cases Eletrobrás has the option to acquire back a 30% stake, through a capital increase.

The table below brings a few data points and shows the huge potential at Cepisa and Ceal. We believe Equatorial is likely to make accretive rates of return on both assets (when looking at EV multiples, it is important to remember that asset bases will grow significantly in the following years and that the balance sheets of all three companies contain relevant receivable accounts, on which customers often pay penalties and interest for being late, a revenue source not accounted for in the regulatory rate-making process). Moreover, these "beautiful" regulated distribution assets that are highly coveted all around the world, even in places where ROEs cannot go meaningfully above regulatory levels (as they do in Brazil for reasons we discussed in previous reports), have now become much more scarce in Brazil.

Company	Net Asset Base (RAB) - R$MM *1	Clients (Thousands)	RAB / Client - R$	OPEX / Client - R$ *2	Power losses *2	Enterprise Value - R$MM *3	EV / RAB	Initial Equity Investment - R$MM
CEMAR	3,700.00	2,468.00	1,499.19	193.00	16.40%	6,450.00	1.74	
CEPISA	1,150.00	1,263.00	910.53	341.00	20.30%	2,300.00	2.00	816.00
CEAL	900.00	1,157.00	777.87	258.00	21.95%	1,700.00	1.89	546.00

* 1 - Nebraska's estimate.

* 2 - Reality number for Cemar (our adjusted numbers, accounting for recurring contingencies); regulatory targets for Cepisa and Ceal (without the temporary surcharge at Ceal).

* 3 - Market data for Cemar and Nebraska's estimate for Cepisa and Ceal, including a fair value estimate for long term, cheap debt, as well as contingencies and suppliers to be settled.

Just two notes on the table: (1) as Cepisa and Ceal improve operationally, their regulatory targets (for OPEX and power losses) will get tougher, as they already are for Cemar, but likely still enabling attractive rates of return on capital; and (2) Cemar's EV/RAB shows how compelling is our investment in its shares directly (30% of our fund) – although its asset base won’t grow nearly as much as Cepisa’s and Ceal’s, it will still grow nicely and, most importantly, Cemar is already and undoubtedly delivering superb returns.

Equatorial has gone a long way since our initial investment in November, 2013. We are glad for having partnered with the company and its employees. Nonetheless we are cognizant of the fact that a lot has already happened in terms of inorganic capital allocation, and that the future will likely look less bright in that regard, especially from a combined scope-and-return perspective (the former, obviously, relative to the company’s size). We hope and trust management also recognizes this and don’t try to repeat the last years at any cost; it won’t be easy though, as the company will begin to throw off huge free cash flows in a few years. Operationally, on the other side, the work on the transmission lines has barely begun (although it is advancing ahead of schedule), there is still a lot to improve at Celpa (Equatorial’s largest distribution subsidiary, acquired in 2012), and everything remains to be done at Cepisa and Ceal. There is enough on the plate for many years, to which we look forward.

We appreciate your attention,

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