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Research Update:

Oi S.A. 'BBB-' Ratings Placed On Watch Negative Following Announced Merger With Portugal Telecom SGPS S.A.

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Overview

- Brazil-based telecommunications company Oi announced a memorandum of understanding for a proposed merger of Oi, Portugal Telecom, and Oi holding companies.
- The transaction will be funded through a capital increase in cash of R\$7 billion to R\$8 billion and a capital increase in kind of about R\$6.1 billion from the contribution of Portugal Telecom's assets.
- We have placed the global scale 'BBB-' and national scale 'brAAA' ratings on Oi on CreditWatch with negative implications.
- The negative CreditWatch listing reflects the possibility of a downgrade, because based on our preliminary assessment, it should take longer for the combined entity to show the stronger credit protection measures that were supporting the stable outlook on Oi.

Rating Action

On Oct. 2, 2013, Standard & Poor's Ratings Services placed its global scale 'BBB-' and national scale 'brAAA' ratings, including the corporate credit rating, on Oi S.A. and its subsidiary, Telemar Norte Leste S.A. (TMAR), on CreditWatch with negative implications.

Rationale

The CreditWatch placement follows Oi's announcement today that it has signed a memorandum of understanding for a proposed merger of Oi S.A., Portugal Telecom SGPS S.A. (PT), and Oi holding companies. The transaction will be funded through a capital increase in cash of R\$7 billion to R\$8 billion and a capital increase in kind of about R\$6.1 billion derived from the contribution of PT assets. The company expects to close the transaction in the first half of 2014.

Under the proposed merger, Oi, PT, and Oi's holding companies--LF Tel S.A., AG Telecom Participações S.A., and Telemar Participações S.A. will be combined. The new structure will have one holding company based in Brazil, which will be the only listed company of the group.

Under our preliminary assessment, we understand that the combined entity would incorporate debt from the above mentioned companies, although part of the debt

would be paid down with the cash capital increase. On the cash generation side, we would expect to see Oi's improving EBITDA generation combined with a pressured EBITDA generation from PT's operation. As a result, under our preliminary assessment, the combined company would post a total debt to EBITDA close to 4.0x and funds from operations (FFO) to debt between 15% and 20% in 2014 and 2015. The negative CreditWatch listing reflects the possibility of a downgrade due to the new entity's expected weaker credit metrics than our current expectations for Oi.

We would probably view the new entity's business risk profile as "satisfactory." The transaction would result in higher scale, more geographic diversification, and some operational synergies. However, the transaction would worsen our view of country risk exposure, as the combined entity would be exposed to Portugal's weaker macroeconomic environment. In any case, we believe that Oi could benefit from the experience of PT's management through an efficient cost structure to improve its profitability.

PT is Portugal's leading integrated provider of telecommunications services, and owns an overall 23% direct and indirect stake in Oi S.A. The group also has other mobile operations, most of them held through a 75% stake in Africatel Holdings B.V. PT's effective stakes in these companies are roughly within a 25%-51% range.

CreditWatch

We expect to resolve the CreditWatch listing once the transaction is approved by the required parties and we further evaluate the combined entity's capital structure and liquidity and its strategy to reduce its debt. Also based on current preliminary evaluation of the transaction, we expect to lower the rating on Oi by no more than one notch if the merger is completed.

Related Criteria And Research

- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

To

From

Oi S.A.

Telemar Norte Leste S.A.

Corporate Credit Rating

Research Update: Oi S.A. 'BBB-' Ratings Placed On Watch Negative Following Announced Merger With Portugal Telecom SGPS S.A.

Global Scale Rating	BBB-/Watch Neg/--	BBB-/Stable/--
Brazil National Scale	brAAA/Watch Neg/--	brAAA/Stable/--

Oi S.A.

Senior Unsecured

Global Scale Rating	BBB-/Watch Neg	BBB-
Brazil National Scale	brAAA/Watch Neg	brAAA

Telemar Participacoes S.A.

Senior Unsecured

Brazil National Scale	brAA+/Watch Neg	brAA+
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