MOODY'S
INVESTORS SERVICE

Credit Opinion: Mato Grosso, State of - DRAFT - In Progress or Approved Version

Global Credit Research

Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa1.br
Issuer Rating	Baa3

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Key Indicators

Mato Grosso, State of Highlights (as of 12/31)	2008	2009	2010	2011	2012
Net Direct and Indirect Debt/Operating Revenue (%)	67.1	56.4	52.1	43.9	38.1
Interest Payments/Operating Revenue (%)	5.2	5.6	6.1	4.3	1.8
Gross Operating Balance/Operating Revenue (%)	15.7	8.8	8.2	8.1	11.0
Cash Financing Surplus(Requirement)/Total Revenue (%)	5.8	(2.7)	2.3	2.2	4.8
Capital Spending/Total Expenditures (%)	11.2	13.2	8.5	7.5	7.5
Intergovernmental Transfers/Operating Revenue (%)	29.8	28.8	28.5	29.6	27.0
Self-financing Ratio	1.6	0.8	1.3	1.3	1.7

Opinion

SUMMARY RATING RATIONALE

The issuer ratings of Baa3 (Global Scale) and Aa1.br (Brazil National Scale) assigned to the State of Mato Grosso reflect a strong track record of positive gross operating balances which have allowed the state to finance its capital requirements internally and with minimal new borrowing. These strong operating margins have led to cash financing surpluses in each of the last six years, except in 2009, when the state recorded a modest deficit of -2.7% of total revenues. The ratings also reflect low and declining debt to revenue levels, which represented 38.1% of the operating revenues in 2012. While Mato Grosso's economy is highly concentrated in the agricultural sector, income levels in the state are in line with the national average, supporting Mato Grosso´s relatively strong own-source revenue base. The ratings also incorporate fiscal challenges including growing pressures on rigid personnel costs together with increasing infrastructure requirements.

National Peer Comparison

The State of Mato Grosso is rated at the middle of a narrow rating range of the seven rated regional and local governments in Brazil, whose ratings span from Ba1 to Baa2. Mato Grosso's position relative to national peers reflects solid financial metrics, low debt levels and strong management factors.

Credit Strengths

The State of Mato Grosso's credit strengths include:

- Strong track record of positive gross operating and cash financing balances

- Low and declining debt burden

- Relatively strong governance and management practices

Credit Challenges

The State of Mato Grosso's credit challenges include:

- Highly concentrated economy on the agricultural sector

- Rigid expenditure base driven by personnel costs

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

A consolidation of the positive financial performance and/or a further easing of debt to revenue levels could exert upward pressure on the rating. The continuation of prudent fiscal policies is also key to the maintenance of current assigned ratings.

What Could Change the Rating - Down

A deterioration in the state's financial performance resulting in recurrent, sizeable financing deficits and a significant rise in the debt burden would exert downward pressure on the rating. A worsening of macroeconomic conditions that might affect international commodity prices and, consequently, Mato Grosso's economy, could also lead to a downgrade of the ratings.

DETAILED RATING CONSIDERATIONS

The rating assigned to the State of Mato Grosso combines the baseline credit assessment (BCA) for the state and the likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

The State of Mato Grosso's BCA of baa3 reflects the following factors:

Financial Performance and Debt Profile

Mato Grosso's sound financial performance is underpinned by a proven capacity to match revenue and expenditure growth in a sustainable pattern and by a relatively strong own-source revenue base, partly offset by increasing pressures on personnel spending and growing infrastructure needs over the medium term.

During the last five years, the state's revenues have grown at a 10.4% compound annual growth rate (CAGR), compared to the 10.7% in expenditures. Such ongoing trend of roughly balanced revenue and expenditure growth has allowed the state to record a solid trend of both positive gross operating balances and cash financing surpluses. Between 2008 and 2012, gross operating balances have averaged 10.4% of operating revenues and when capital accounts are incorporated, cash financing surpluses accounted for 2.5% of total revenues. Only in 2009, year in which Brazil's economy detracted by -0.6%, the state posted a modest cash financing deficit equivalent to -2.7% of total revenues.

Mato Grosso's sizable tax base is essentially supported by the ICMS, a value-added sales tax. In 2012, ICMS represented more than 88% of local tax collection. It is worth noting that throughout the economic slowdown of 2009 the ICMS continued to perform strongly (at a 4% annual increase), showing a proven capacity to withstand potential economic shocks. The state's own-source revenues represent a high 73% while the remaining 27% are federal transfers.

Fiscal challenges for Mato Grosso persist, including growing pressures on rigid personnel costs together with increasing infrastructure requirements. Personnel costs have gained share within the state's spending flow increasing from 46% of total expenditures in 2008 to 53% in 2012. The rate of growth of personnel costs has outpaced operating revenues: while personnel costs increased at a 15% CAGR between 2008 and 2012, operating revenues increased by 10% in the same period. Going forward, the state will have to continue on its efforts to keep personnel spending in line with revenue growth in order to ensure balanced fiscal outcomes.

The State of Mato Grosso has a relatively low and declining debt burden, with net direct and indirect debt amounting to 38% of total revenues in 2012, down from 97% in 2006. This is a low level within the Brazilian context.

Borrowing activity has remained negligible in recent years due to federal restrictions on bond issuance imposed through a debt refinancing agreement signed in 1997 and the national Fiscal Responsibility Law enacted in 2000. Nevertheless, during 2012 the State of Mato Grosso refinanced part of its debt with the national government with a loan from Bank of America (with the guarantee of the federal government) for BRL 979 mn. The national government remains as Mato Grosso's main creditor holding more than 50% of the state's net direct and indirect debt in 2012, down from more than 80% in 2011. The state also has loans with national financial institutions--Banco do Brasil, BNDES and Caixa Econômica Federal--and with the World Bank.

Additionally, potential increases in CAPEX related to the 2014 FIFA World Cup (Cuiabá, Mato Grosso's capital city will be one of the host cities) do not represent a credit challenge since the projects do not carry significant amounts and are being financed with planned borrowing from BNDES (the national development bank) and Caixa Econômica Federal.

Governance and Management

Mato Grosso typically meets its fiscal targets having posted positive gross operating balances and cash financing results. The state's relatively conservative governance and management practices are also reflected by the maintenance of a manageable debt burden along many years.

The state prepares timely and comprehensive annual and periodic interim financial statements, including balance sheets, although they are not independently audited.

The current administration has been in power since January 1st 2011 and is particularly focused on fostering prudent fiscal policies with targeted spending goals and the implementation of systems to improve tax collection. Financial operations are run by a professional team with considerable expertise.

Economic Fundamentals

With 3 million inhabitants, Mato Grosso is one of Brazil´s states with the lowest population. Its economy produces around 1.6% of the national output. In spite of the low GDP contribution, Mato Grosso's income levels are aligned with the national average and support a relatively strong own-source revenue base.

Agriculture and the service sector are the largest components of the state's GDP at around 40% each, followed by industry, which accounts for the remaining 20%. Mato Grosso is the largest soybeans producer and the second largest rice producer state in the country.

Mato Grosso's economy is highly concentrated in the primary agricultural sector and, therefore, it depends significantly on international commodity prices. The government is promoting the development of the agro-industrial sector through facilitating the establishment of companies with, --among other things--directed tax incentives.

Institutional Framework

The institutional framework which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, is well-established, featuring a predictable system of federal fiscal transfers and close supervision over state finances and debt. While revenue flexibility is boosted by the states' access to important own source revenues, including exclusive use of the VAT-like ICMS tax, states also operate under considerable budgetary constraints due to earmarking of their revenues and expenditure rigidity related to personnel and debt service costs.

Extraordinary Support Considerations

Moody's assigns a moderate likelihood of extraordinary support from the federal government, reflecting a history of defaults at the state level of government and Moody's assessment of the federal government's fiscal policy framework, which is focused on fostering greater accountability at the state level, offset by a medium degree of fiscal oversight.

Output of the Baseline Credit Assessment Scorecard

In the case of the State of Mato Grosso, the BCA matrix generates an estimated BCA of ba1, close to the BCA of baa3 assigned by the rating committee.

The matrix-generated BCA of ba1 reflects (1) an idiosyncratic risk score of 4 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Baa2, as reflected in the sovereign bond rating (Baa2, stable).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in October 2012 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Mato Grosso, State of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	101.28	70%	5	20%	1.00
Economic volatility	5		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	4	20%	0.80
Financial flexibility	3		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	8.22	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	5	4.99	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	43.89	25%			
Short-term direct debt / total direct debt (%)	3	16.25	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	5					
Idiosyncratic Risk Assessment						4.13(4)
Systemic Risk Assessment						Baa2
Suggested BCA						ba1