FitchRatings

Fitch Affirms ENEA at 'BBB'; Outlook Stable

Fitch Ratings-Warsaw/London-01 October 2018: Fitch Ratings has affirmed Poland-based ENEA S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB' with Stable Outlooks.

The affirmation reflects ENEA's changed business profile with a higher contribution to EBITDA from more risky electricity generation and coal mining, but still significant input from the more predictable distribution of electricity. We anticipate that rising CO2 and coal prices will have only a limited impact on results of the generation business as we expect them to be reflected in rising wholesale electricity prices in the Polish market.

We deem ENEA's involvement in the 1GW coal-fired power plant Ostroleka C project as credit negative. However, with ENEA's expected participation of about PLN1 billion, which we assume will be offset by suspension of dividends by 2022, our funds from operations (FFO) adjusted net leverage should stay below the negative rating guideline of 3.0x.

KEY RATING DRIVERS

Changed Business Profile: ENEA's business profile has changed following the acquisition of power generation company ENGIE Energia Polska S.A. (ENGIE Poland) in 2017 and Bogdanka coal mine in 2015, which increased the scale of the generation business and expanded ENEA's value chain to coal mining. Together with the commencement of operations at the new 1GW coal-fired block in Kozienice in 4Q17 and the rising prices of coal, both the generation and mining divisions have been reporting higher EBITDA and increased their share in the mix.

Distribution Supports Credit Profile: ENEA's credit profile continues to benefit from the stable and predictable electricity distribution business, which is characterised by lower business risk than conventional generation and mining. The share in EBITDA (40% in 2018) has decreased compared with the 2014 peak of close to 60% due to ENEA's expansion in conventional generation and mining. We anticipate that the distribution segment's share in EBITDA will remain at about 40% over our rating horizon, supporting ENEA's credit profile.

Rising CO2 and Coal Prices: We expect that ENEA's coal-fired generation business will come under limited pressure from rising CO2 and coal prices. This is due to the low interconnectivity of the Polish market and domination of coal-fired generation in the country's fuel mix. Consequently, higher generation costs affect most of the market and are reflected in rising wholesale electricity prices. We expect this pass-through effect to gradually weaken, but only in the long term. Wholesale electricity prices have been increasing, even in the typically lower-price markets like Germany and Scandinavia, hence imports, even if technically possible, would be less competitive.

ENEA benefits from partial allocation of free CO2 allowances in exchange for environment-friendly capex similarly to many other central European generation companies. We currently assume that the mechanism will not be extended beyond 2020. The key risk mitigant on the coal pricing side is ownership of a low production cost coal mine, Bogdanka, and ability to benefit from increasing coal prices through the mining division.

Ostroleka C Project: ENEA will likely participate in the construction of the new coal-fired block in Ostroleka with Energa S.A. (BBB/Stable). The exact structure of the project is unknown yet, but both ENEA and Energa declared that their stakes in the project would not exceed PLN1 billion each with another up to PLN1 billion likely to be provided by a local investment fund managed by TFI Energia. The remainder (about PLN3 billion) could be provided either in form of equity or non-recourse debt by investors at the project company level. In Fitch's rating case we assume that ENEA will contribute PLN1 billion to the project in form of equity. A higher contribution would be negative for ENEA's credit profile and could lead to negative rating action.

Ostroleka C Risks: Participation in the Ostroleka C project would further increase ENEA's exposure to generation business, which is negative for its credit profile. However, some mitigants exist, including implementation of the project in partnership with Energa and other third-party financial investors, introduction of a capacity market in Poland with first capacity auctions planned for late 2018 and a favourable coal price formula in the supply contract with domestic coal mining group Polska Grupa Gornicza (PGG), supporting the margin on power generation.

Capacity Market Crucial: We view the capacity market in Poland as crucial in allowing new coal power plants under construction or in the planning stage, such as the Ostroleka C plant, to be operationally profitable and to provide a return on invested capital. ENEA's ratings would come under pressure if the Ostroleka C project was implemented without capacity payments supporting cash flow and consequently without the support of financial investors.

High, but Manageable Leverage: In our rating case we assume no dividends over 2019-2022 (similarly to 2018 when the company did not pay dividends) and include cash outflows for the Ostroleka C project of about PLN1 billion. We expect relatively high capex and acquisitions, including Ostroleka C, at close to PLN13 billion over 2018-2022. Consequently, we expect FFO adjusted net leverage to increase and average 2.8x over 2018-2022 (2.5x in 2017). This is below the negative rating guideline of 3x, but leaves limited rating headroom.

Rated on Standalone Basis: We assess ENEA's links with the Polish state (A-/Stable), which owns 51.5% of the company, under our Government-Related Entities (GRE) rating criteria. Based on these criteria, ENEA is rated on a standalone basis, which is the same approach as under the parent and subsidiary rating linkage criteria. Under the GRE criteria, we assess status, ownership and control as strong with the three remaining factors as weak, including support track record and expectations, socio-political impact and financial implications of ENEA's hypothetical default.

DERIVATION SUMMARY
ENEA has a lower share of regulated distribution than the two other 'BBB' rated Polish integrated utilities, TAURON Polska Energia S.A. (Tauron, BBB/Stable) and Energa, and a higher exposure to more risky and cyclical mining division. This is reflected in Fitch's lower maximum leverage guideline within the ratings of 3.0x for ENEA and 3.5x for Tauron and Energa.

The largest Polish utility PGE Polska Grupa Energetyczna S.A. (BBB+/Stable) has a high share of lignite in its generation fuel mix, which has let the company achieve cost advantage over its hard coal-fired Polish peers. Rising CO2 prices could diminish this cost advantage if not accompanied by rising hard coal prices, due to higher carbon footprint of lignite when compared to hard coal. PGE has also the lowest leverage among Fitch-rated electricity-utilities in Poland.

All four Polish integrated utilities have limited rating headroom due to a projected increase in leverage driven by large capex and changing market conditions.

KEY ASSUMPTIONS
Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Weighted average cost of capital in the distribution segment at 6.0% in 2018-2022
- 5% reduction in the return on the distribution's regulated asset base from 2018
- Wholesale electricity prices rising from about PLN200 to PLN250 per megawatt-hour, coal prices rising from about PLN200 to PLN300 per tonne and prices of carbon dioxide allowances rising from about EUR15 to EUR20 per tonne over 2018-2022 (all prices on an average, annual basis)
- Reduced margins in the supply business to ease impact of higher wholesale electricity prices, in particular on households
- Total capex and acquisitions of close to PLN13 billion over 2018-2022, including PLN1 billion as investment in the Ostroleka C project
- No dividends paid by ENEA over 2018-2022

RATING SENSITIVITIES
Rating upside potential for ENEA is limited due to the company's large capex and acquisition plans, business risk profile including a large portion of mining and changing market conditions in the generation business as well as our expectation that FFO adjusted net leverage will increase to close to 3x limit for the ratings. However, future developments that could lead to positive rating action include:
- Stronger-than-expected cash flow generation or reduction of capex and acquisition plans leading to projected FFO adjusted net leverage sustained below 2x, supported by management's more conservative leverage target;
- A more diversified fuel generation mix and lower CO2 emissions per megawatt-hour, which together with continued efficiency improvements, would result in a stronger business profile.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Increase in FFO adjusted net leverage to above 3x or FFO fixed charge cover below 5x on a sustained basis due, for example, to full implementation of the capex plan or acquisitions in a scenario of low operating cash flows;
- Substantial adverse change in ENEA's business profile, such as a material reduction in the share of regulated distribution in total EBITDA or higher generation costs not reflected in wholesale electricity prices;
- Involvement in Ostroleka C project construction phase without secured cash flow support from the capacity market and without the involvement of financial investors, or in a scenario of large dividends paid to shareholders.

LIQUIDITY
Adequate Liquidity: At end-June 2018 ENEA had unrestricted cash of PLN2.8 billion and committed unused credit lines of PLN1.0 billion against short-term debt of PLN0.5 billion, Fitch-projected negative free cash flow including acquisitions of PLN0.4 billion (negative) for 2018 and PLN0.9 billion (negative) for 2019.

The next large debt repayments are scheduled for 2020, when about PLN2 billion of bank-tailored and market bonds mature. We expect ENEA to begin the process of refinancing at least 12 months in advance of the maturity dates.

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Summary of Financial Statement Adjustments - Operating lease is capitalised with 7x multiple.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018) (https://www.fitchratings.com/site/re/10019302)
Sector Navigators (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023790)

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