FITCH AFFIRMS POLAND'S ENERGA AT 'BBB'; OUTLOOK STABLE

Fitch Ratings-Warsaw/London-28 November 2016: Fitch Ratings has affirmed Poland-based Energa S.A.'s Long-Term foreign- and local-currency Issuer Default Ratings (IDRs) at 'BBB' with a Stable Outlook. A full list of rating actions is at the end of this rating action commentary.

The affirmation reflects the dominant share of the regulated electricity distribution business in Energa's EBITDA and the capex plan. It also takes into account increased business risk due to the reinstatement of a 1GW coal-fired power plant Ostroleka C project, which was put on hold in 2012. Risks related to Ostroleka C are mitigated by the planned construction of the plant in a partnership, expected introduction of a capacity market in Poland and a favourable coal price formula in the coal supply contract.

The company's financial leverage is moderate, with funds from operations (FFO) adjusted net leverage of 1.9x in 2015. We forecast that this ratio will increase to about 3.5x in 2018-2020, which is the maximum leverage commensurate with the 'BBB' rating.

KEY RATING DRIVERS

Distribution Supports Credit Profile

Energa's creditworthiness benefits from a high EBITDA contribution from regulated electricity distribution (75% of 2015 adjusted EBITDA), characterised by a lower business risk and better cash flow predictability than conventional generation. We expect the share of regulated EBITDA to average close to 80% in 2016-2020, contributing to cash flow visibility.

Despite allocating fairly large capex for power generation by 2025 (about 30% in 2016-2025), distribution continues to dominate Energa's capex plan with about 65% in 2016-2025.

Ostroleka C Project Increases Business Risks

Until May 2016, Energa was the only company out of the four Fitch-rated Polish utilities that was not involved in the new coal-fired power plant projects, due to its focus on the distribution segment. In our view, the reinstatement of Ostroleka C increases business risks for Energa given weak market conditions for conventional power generation.

Risks related to Ostroleka C are mitigated by the planned construction of the plant in a 50:50 partnership with another Polish integrated utility, ENEA S.A (BBB/Stable), which has recent experience in constructing a coal-fired plant. The risks of Ostroleka C are also mitigated by the expected introduction of a capacity market in Poland and a favourable coal price formula in the supply contract with domestic coal mining group Polska Grupa Gornicza Sp. z o.o. (PGG), supporting the margin on power generation.

Strategy Drives Leverage Increase

We view the capex plan in the strategy published in November 2016 as large in the context of Fitch's lower projections for 2017-2020 EBITDA. The new strategy assumes total capex of PLN20.6bn for 2016-2025, which is about 2% more a year than the previous plan for 2014-2022.

According to our projections, the large capex will drive FFO adjusted net leverage to about 3.5x in 2018-2020 from 1.9x in 2015. We view 3.5x as the maximum leverage commensurate with the ratings, leaving no rating headroom for Energa in this period based on our rating case projections. However, Energa has some flexibility in the capex plan and may postpone or cancel some projects.

The company also plans further efficiency enhancements and plans to issue up to EUR250m hybrid bonds to European Investment Bank to co-finance capex in distribution. All these actions may improve credit metrics and increase rating headroom. We assume no dividend payments for 2017-2020 in our rating case.

Financial Policy
One of the key elements of Energa's strategy is to maintain its investment-grade rating and the net debt/EBITDA ratio below the covenant of 3.5x. Energa plans to implement two large projects in generation, Ostroleka C and a 80MW hydro power plant on the Vistula river, in partnerships to share the projects' capex and risks and lower the projects' negative impact on credit metrics.

The capex will peak in 2021-2023, the period for which most of the capex for the Ostroleka C project and a substantial part of the capex for Vistula is planned. This is beyond our five-year horizon for the rating. However, if FFO adjusted net leverage will be above 3.5x in 2021-2023 this may lead to negative rating action in 2018-2019.

Energa expects that both projects will receive additional cash flow support, for instance, capacity payments in the case of Ostroleka C. Implementation of Ostroleka C without a new capacity market mechanism may be negative for the rating. We do not include any cash inflows related to the contemplated capacity market in our rating case forecast until 2020.

Rated on Standalone Basis
Energa is 51.52%-owned by the Polish state (A-/Stable), but Fitch rates it on a standalone basis because we assess legal, operational and strategic links with the state as moderate based on our Parent and Subsidiary Rating Linkage criteria. In our view, the links have had an incrementally stronger impact on the company under the new government, which has been in place since November 2015. Examples include a less-generous dividend policy, which is aligned to the investment process including the reinstatement of Ostroleka C project.

DERIVATION SUMMARY
Energa's and TAURON Polska Energia S.A.'s (Tauron, BBB/Stable) business profiles benefit from the large share of regulated distribution in EBITDA, which provides good cash flow visibility at times when another key segment, conventional power generation, is under pressure. This supports the rating. Two other Polish utilities, PGE Polska Grupa Energetyczna S.A. (BBB+/Stable) and ENEA, have lower share of regulated distribution than Tauron and Energa.
Energa has weaker conventional generation assets than its Polish peers.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Weighted average cost of capital in the distribution segment reduced to 5.7% in 2016 from 7.2% in 2015 (and 6.8% when applying the one-off haircut applied by the regulator), before gradually increasing to 6% in 2020.
- 5% haircut reducing return on the distribution's regulated asset base incorporated from 2018.
- Wholesale baseload power prices falling to about PLN155 per MWh by 2019-2020.
- Capex and acquisitions of about PLN10bn in 2016-2020.
- No dividends in 2017-2020.

RATING SENSITIVITIES
Positive: Developments that may, individually or collectively, lead to positive rating action include:
- Continued focus on the distribution business in capex and overall strategy, together with FFO adjusted net leverage below 2.5x on a sustained basis, supported by management's more conservative leverage target.

- Improvements in the regulatory framework, together with distribution networks remaining a dominant earning stream for Energa, may lead to an upgrade of Energa's and Energa Finance AB (publ)'s senior unsecured rating in a one-notch uplift over the Long-Term IDR.

Negative: Developments that may, individually or collectively, lead to negative rating action include:
- Increase in FFO adjusted net leverage to above 3.5x or FFO fixed charge cover below 5x on a sustained basis, for example, due to full implementation of capex, acquisitions and weaker-than-expected operating cash flow.
- Acquisitions of stakes in coal mines or other form of support for state-owned mining companies under financial pressure leading to net leverage above 3.5x or substantially worsening Energa's business profile.
- A substantial tax payment arising from an increase in the nominal value of Energa's shares. This is a cash flow and operating environment risk for Energa and other Polish state-controlled utilities as the government contemplates an increase of the nominal value of their shares. Such an increase would be subject to approval at the shareholders' meeting. This tax payment is not included in our assumptions for the rating case. We treat this as event risk and a potential corporate governance issue.

LIQUIDITY
Adequate liquidity: Energa has sufficient liquidity position and well spread debt maturity profile. At end-September 2016, Energa had Fitch-calculated readily available cash of PLN0.4bn against short-term debt of PLN0.2bn. Energa's committed financing at end-September 2016 amounted to PLN1.8bn. We project negative free cash flow of PLN0.5bn for 2016. The first large debt repayment is not due until 2019, when PLN1.3bn of gross debt (and PLN0.7bn of net debt) matures.

FULL LIST OF RATING ACTIONS

Energa S.A.
Long-Term foreign-currency IDR affirmed at 'BBB'; Stable Outlook
Long-Term local-currency IDR affirmed at 'BBB'; Stable Outlook
National Long-Term rating affirmed at 'A+(pol)'; Stable Outlook
Foreign-currency senior unsecured rating affirmed at 'BBB'
Local-currency senior unsecured rating affirmed at 'BBB'
National senior unsecured rating affirmed at 'A+(pol)'

Energa Finance AB (publ), guaranteed by Energa S.A.
Foreign-currency senior unsecured rating affirmed at 'BBB'

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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
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
https://www.fitchratings.com/site/re/885629
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557