



Fitch Affirms Poland's Energa at 'BBB'; Outlook Stable

Fitch Ratings-Warsaw/London-21 March 2018: 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, the capex plan and the company's prudent financial policy. Risks related to a 1GW coal-fired power plant Ostroleka C project are mitigated by the planned implementation of the project in a partnership and introduction of a capacity market in Poland.

The company's financial leverage is moderate, with funds from operations (FFO) adjusted net leverage of 1.7x in 2017, supported by better than expected cash flows in 2017 and also the EUR250 million (PLN1.1 billion) hybrid bond issue in September 2017. We forecast that net leverage will increase to about 3x in 2018-2022, assuming Energa's partial involvement in the Ostroleka C project and no dividends to be paid by Energa during the Ostroleka C construction phase. This leverage is comfortably below the 3.5x negative threshold for the rating.

KEY RATING DRIVERS

Distribution Supports Credit Profile: Energa's creditworthiness benefits from a high EBITDA contribution from regulated electricity distribution (78% of 2017 EBITDA), characterised by lower business risk and better cash-flow predictability than conventional generation. We expect the share of regulated EBITDA to average about 80% in 2018-2020, contributing to cash-flow visibility.

Ostroleka C Risk Mitigants: The reinstatement of the Ostroleka C coal-fired power plant project in 2016 increased business risk for Energa, given weak market conditions for conventional power generation. Risks related to Ostroleka C are mitigated by the planned implementation of the project in partnership with another Polish integrated utility, ENEA S.A (BBB/Stable), which has recent experience in constructing a coal-fired plant (completed construction of a 1.1GW coal-fired plant in Koźienice). ENEA's existing coal-fired capacity is also much larger than Energa's (close to 6GW vs. 0.7GW). Planned involvement of third-party financial investors in Ostroleka C further lowers Energa's exposure to the project.

The risks of Ostroleka C are also mitigated by the 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.

Ostroleka C Funding Structure: Energa plans to have joint control over Ostroleka C with ENEA, but to also involve third-party financial investors in the project. We assume that Ostroleka C will be funded at the SPV level with participation of financial investors as debt or equity holders. We understand from Energa that notice to proceed with the project will only be issued if Ostroleka C wins a capacity market auction scheduled for late 2018, which would enhance the project's cash flows. Energa expects that by that time a financing structure for the project will have been agreed with ENEA and financial investors.

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 in the current unfavourable market conditions. Energa's ratings would come under negative pressure if the Ostroleka C project was implemented without capacity payments supporting cash flow and, consequently, without the support of financial investors.

The act on the capacity market, prepared by the Polish government, came into force in January 2018 and the capacity mechanism was approved by the European Commission in February 2018. The first capacity auctions are planned for November and December 2018 and the capacity payments for winners of the 2018 auctions should be available from 2021, 2022 or 2023.

Financial Policy: One of the key elements of Energa's strategy is to maintain its investment-grade rating and its net debt/EBITDA ratio below the covenant of 3.5x. Energa plans to implement two large projects in generation, Ostroleka C and an 80MW hydro power plant on the Vistula river, in partnerships to share the projects' capex and risks, and lower the negative impact on credit metrics. In addition to the EUR250 million hybrid bonds issue in September 2017, which slightly improved the leverage ratio due to 50% equity credit, Energa has some flexibility in its capex plan and may postpone or cancel some projects. We assume no dividends in 2018-2022 due to large capex.

Rated on Standalone Basis: We now assess Energa's links with the Polish state (A-/Stable), which owns 51.52% of the company, under our Government-Related Entities (GRE) rating criteria. Based on these criteria, Energa 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 a hypothetical GRE default.

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 ratings. ENEA (BBB/Stable) has a lower share of regulated distribution than Energa and Tauron and therefore a lower debt capacity for the rating.

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% for 2018 increasing to about 6.6% in 2022;
- Capex and minority acquisitions at PLN9.5 billion for 2018-2022;
- Participation of third-party financial investors, beyond Energa and ENEA, in the Ostroleka C project, which we deem as likely following approval by the EC of the capacity market framework in Poland;
- The Ostroleka C project wins the capacity auction with capacity payments from 2023;
- No dividends in 2018-2022.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

- 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, could lead to an upgrade of Energa's and Energa Finance AB (publ)'s senior unsecured rating due to the application of a one-notch uplift over the Long-Term IDR.

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- 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.
- Construction of Ostroleka C without secured capacity payments for the project and without the involvement of financial investors.

LIQUIDITY

Adequate Liquidity: Energa has sufficient liquidity. At end-2017 Energa had Fitch-calculated readily available cash of PLN3.6 billion against short-term debt of PLN0.5 billion. Energa's committed unused financing at end-2017 amounted to PLN1.0 billion. The first large debt repayment is due in 2020, when EUR500 million Eurobonds mature. The issue of EUR300 million Eurobonds in 2017 has supported the company's liquidity, whereas the issue of hybrid bonds supported also its financial structure as it qualified for a 50% equity credit under Fitch hybrid methodology.

FULL LIST OF RATING ACTIONS

Energa S.A.

Long-Term Foreign- and Local-Currency IDRs affirmed at 'BBB'; Stable Outlook

Foreign- and local-currency senior unsecured ratings affirmed at 'BBB'

Hybrid bonds affirmed at 'BB+'

National Long-Term Rating affirmed at 'A+(pol)'; Stable Outlook

National senior unsecured rating affirmed 'A+(pol)'

Energa Finance AB (publ) (guaranteed by Energa S.A.)

Foreign-currency senior unsecured rating affirmed at 'BBB'

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Summary of Financial Statement Adjustments - 50% equity credit was allocated to EUR250 million hybrid bonds, debt value is adjusted for hedging

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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. 07 Aug 2017) (<https://www.fitchratings.com/site/re/901296>)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018) (<https://www.fitchratings.com/site/re/10019302>)
National Scale Ratings Criteria (pub. 07 Mar 2017) (<https://www.fitchratings.com/site/re/895106>)
Non-Financial Corporates Hybrids Treatment and Notching Criteria (pub. 27 Apr 2017) (<https://www.fitchratings.com/site/re/896881>)

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