FitchRatings

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

Fitch Ratings - Warsaw - 03 June 2019:

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 below.

The affirmation reflects the dominant share of the regulated electricity distribution business in Energa's EBITDA and capex plan, and the company's prudent financial policy. Risks related to a 1GW coal-fired power plant Ostroleka C are mitigated by introduction of a capacity market in Poland and implementation of the project in a partnership.

We forecast that Energa's funds from operations (FFO) adjusted net leverage will increase to about 3.5x in 2019-2020 from a moderate 2.2x in 2018 and to decrease thereafter to around 3.2x in 2021. This leaves Energa with no rating headroom under our negative rating sensitivity of 3.5x for a couple of years. Leverage increase is driven mainly by large capex in 2019-2020 and cash outflows for equity injections into the Ostroleka C project company.

Key Rating Drivers

Distribution Supports Credit Profile: The ratings of Energa reflect its focus on regulated distribution activity, its main business segment, which is characterised by lower business risk and greater cash flow predictability than conventional power generation. Energa has a high EBITDA contribution from regulated electricity distribution (87% of 2018 Fitch-calculated EBITDA, driven also by negative results in supply, up from 78% in 2017). We expect the share of regulated EBITDA to average 75% in 2019-2023, contributing to cash flow visibility.

Ostroleka C Increases Business Risk: Construction of Ostroleka C started in December 2018 after a successful capacity auction. In our view, this project increases Energa's business risk given challenging market conditions for coal-fired generation and also the more cyclical character of electricity generation compared with distribution's. The risks are mitigated by the introduction of a capacity market and participation of partners in the project.

Support from Capacity Market: The profitability of Ostroleka C will be supported by the revenue from the recently created capacity market. In the capacity auction in December 2018 Ostroleka C was awarded capacity payments for 15 years starting from January 2023, when the plant is expected to become operational. The payments of PLN173 million a year (indexed to CPI) will be a significant contributor to the project's EBITDA and will stabilise cash flows. However, in the first year of operations (i.e. 2023) the project may incur penalties and lost revenue from the capacity market as based on the current schedule the plant will only be completed in September 2023.

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.

Participation of Partners: Risks related to Ostroleka C are mitigated also by 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 Kozienice). ENEA's existing coal-fired capacity is also much larger than Energa's (about 6GW vs. 0.7GW). Planned involvement of third-party equity financial investors in Ostroleka C would further lower Energa's exposure to the project.

Ostroleka C Funding Structure: Capex in the first several months of construction has been funded with equity injections from Energa and ENEA, which in total contributed about PLN1 billion to the project as at end-March 2019. Discussions with financial institutions regarding the target funding structure of the project are ongoing. We expect the funding structure covering total funding needs of Ostroleka C of about PLN6 billion to be finalised by end-2019. Delays in finalising funding beyond 2019 would be credit- negative given the project's progressing construction and would increase the risk of higher contribution from Energa to the project.

We currently assume that Ostroleka C will be largely funded at the SPV level with no recourse to Energa and the company's total contribution to the project will be limited to about PLN1.3 billion.

Leverage Increase: We forecast Energa's FFO adjusted net leverage to increase to about 3.5x in 2019-2020 from a moderate 2.2x in 2018 and to decrease thereafter to around 3.2x in 2021. This leaves Energa with no rating headroom under our negative rating sensitivity of 3.5x for a couple of years. Leverage increase is driven by large capex in 2019-2020 and also cash outflows for equity injections to the Ostroleka C project. In addition, we project working capital outflows in 2019, related to frozen supply tariffs.

We view the company's financial policy as prudent. One of the key elements of Energa's strategy is to maintain the company's rating at the current level and net debt/EBITDA ratio below the debt covenant of 3.5x.

Frozen Supply Tariffs: Fitch assumes that Energa will be fully reimbursed for the deficit between retail electricity prices frozen by the government and higher purchase costs of electricity incurred in 2H18 and 2019. However, for the time being the delay in receipt of compensations contributed to higher net leverage expectations for 2019. The reimbursement mechanism, still to be finalised, leaves some uncertainty for 2020 and beyond. Inability to pass through higher electricity purchase costs without any form of compensation would be credit-negative for Energa.

Rated on Standalone Basis: We assess Energa's links with the Polish state (A-/Stable), which owns 51.52% of the company, under Fitch Government-Related Entities (GRE) rating criteria, and rate Energa on a standalone basis. Under the GRE criteria, we assess status, ownership and control links as strong with the three remaining factors as weak, including support track record and expectations, socio-political impact and financial implications of a GRE default.

Derivation Summary

Energa's close peer group includes the three other electricity-focused integrated utilities in Poland, which are PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), TAURON Polska Energia S.A. (Tauron; BBB/Stable) and ENEA S.A. (BBB/Stable).

Energa's and Tauron's business profiles benefit from a 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, in particular those of Energa, which has the smallest generation fleet among the peers, even after taking into account the under-construction Ostroleka C.

PGE is the largest company and has the lowest leverage in the peer group. It derives most of its EBITDA from electricity generation and has a high share of lignite in the generation fuel mix, which provides the company with cost advantage over hard coal-fired peers, such as Tauron and ENEA. Rising CO2 prices could diminish this cost advantage, given the higher carbon footprint of lignite than hard coal.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time high exposure to hard coal-fired generation and coal mining. This is reflected in Fitch's maximum leverage sensitivity for 'BBB' ratings of 3.0x for ENEA and 3.5x for Tauron and Energa.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Weighted-average cost of capital in the distribution segment flat at 6%

- Capex and minority acquisitions totalling PLN9.5 billion for 2019-2023, including PLN1 billion on the Ostroleka C project over 2019-2020 (null from 2021)

- Participation of third-party investors in the Ostroleka C project with contributions from 2020, as well as ENEA's equity injection of PLN0.8 billion in 2021

- No dividends in 2019-2023

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 than the existing one.

- Improvements in the regulatory framework, together with distribution networks remaining a dominant earning stream for Energa, which 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 that substantially worsen Energa's business profile.

- Energa's guarantees for Ostroleka C's debt, recourse to Energa for project debt, or the project's majority ownership by Energa leading to full consolidation.

Liquidity and Debt Structure

Adequate Liquidity: At end-2018 Energa had cash and cash equivalents of PLN2.7 billion and committed unused credit facilities of PLN1 billion against short-term financial liabilities of PLN0.3 billion and Fitch-calculated negative free cash flow after acquisitions for 2019 of PLN2 billion (driven by higher capex, cash outflows for the Ostroleka C project and working capital outflows in the supply business).

Its liquidity position is sufficient for 2019, but insufficient for 2020 when Energa faces large debt repayments, in particular the EUR500 million (PLN2.1 billion) Eurobond, which matures in March 2020. We expect the company to obtain additional funding in the next few months.

Summary of Financial Adjustments

50% equity credit was allocated to EUR250 million hybrid bonds, debt value is adjusted for hedging.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Energa Finance AB (publ)			
senior unsecured	LT BBB Affirmed		BBB
Energa S.A.	Natl LT A+(pol) ● Affirmed		A+(pol) ●
	LC LT IDR BBB ● Affirmed		BBB ●
	LT IDR BBB ● Affirmed		BBB ●
senior unsecured	LT BBB Affirmed		BBB
senior unsecured	Natl LT A+(pol)		A+(pol)

	Affirmed		
subordinated	LT BB+ Affirmed		BB+

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Government-Related Entities Rating Criteria (pub. 29 Mar 2019)
Corporate Hybrids Treatment and Notching Criteria (pub. 09 Nov 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

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