



## RATING ACTION COMMENTARY

# Fitch Maintains Energa's 'BBB-' IDR on Rating Watch Positive

Thu 20 Jan, 2022 - 5:01 PM ET

Fitch Ratings - Warsaw - 20 Jan 2022: Fitch Ratings has maintained Energa S.A.'s 'BBB-' Long-Term Issuer Default Rating (IDR) on Rating Watch Positive (RWP), where it was placed on 20 May 2021 on the planned merger of Energa's controlling shareholder, Polski Koncern Naftowy ORLEN S.A. (PKN ORLEN; BBB-/RWP), with Grupa LOTOS S.A. (LOTOS) and Polskie Gornictwo Naftowe i Gazownictwo S.A. (PGNiG, BBB/Stable).

Energa's ratings (except for its National Ratings) have been removed from Under Criteria Observation (UCO), where they were placed on 1 December 2021 following the conversion of Fitch's Exposure Draft: Parent and Subsidiary Linkage (PSL) Rating Criteria to final. A full list of rating actions is below.

In our rating approach under the new PSL criteria we equalise Energa's rating with that of PKN ORLEN. The RWP thus mirrors that on the ratings of PKN ORLEN and we expect to resolve the RWP once the transactions, especially PKN ORLEN's merger with PGNiG, are closed.

## KEY RATING DRIVERS

**Revised SCP:** We have revised Energa's Standalone Credit Profile (SCP) to 'bbb-' from 'bbb' due to a higher than previously expected increase in projected leverage by 2024-2025 on the back of a large capex plan. We project funds from operations (FFO) net leverage to increase to an average of 4.7x in 2023-2025 from 2.7x in 2020. Energa's total capex plan amounts to PLN31.5 billion in 2021-2030, of which PLN15.2 billion is in 2021-2025.

**Solid Business Profile:** Energa's SCP is supported by its solid business profile, with a dominant share of predictable regulated electricity distribution business in both EBITDA and capex. The company is planning several large capex projects in power generation, including two gas-fired power plants, Ostroleka C and Grudziadz.

**Linkage with Stronger Parent:** After the revision of Energa's SCP, we view PKN ORLEN as a stronger entity than Energa and follow the stronger parent approach under our PSL criteria. As a result, we assess the legal, strategic and operational incentives for the parent to support the subsidiary.

**Medium Legal Incentives:** We view legal incentives as medium, given the cross-defaults in PKN ORLEN's debt with moderate permanence with regards to Energa, undertakings regarding subsidiary liquidity and in the absence of PKN ORLEN's guarantees for Energa's debt.

**High Strategic Incentives:** Energa is an important part of PKN ORLEN's strategy for energy transition, as an important company under which the parent invests in renewables, including onshore and offshore wind and also in gas-fired power plants. This is a new trend in the strategies of oil and gas companies due to an increased ESG

focus. PKN ORLEN's strategy places Energa as one of its key acquisitions, generating additional EBITDA to meet the 2030 EBITDA goal.

Energa makes a substantial contribution to PKN ORLEN's group profile. In 9M21, Energa's EBITDA of PLN2.1 billion accounted for 21% of PKN ORLEN's LIFO EBITDA. Energa provides a material competitive advantage and growth potential to the parent. PKN ORLEN views Energa as an important subsidiary with more stable cash flow than its more cyclical and risky oil refining and petrochemicals businesses. PKN ORLEN supports Energa through lack of dividend payments given its large capex.

As a result of these factors, we assess strategic incentives as high.

**High Operational Incentives:** Energa is operationally integrated in the PKN ORLEN group. The majority achieved by PKN ORLEN after the acquisitions of Energa's shares in 2020 (91% of capital and 93% of voting rights), common management structure and operational synergies results in our high assessment of operational incentives.

**Rating Construct:** Given medium legal incentives and high strategic and operational incentives, we equalise the rating of Energa with that of PKN ORLEN.

**Regulated Income:** Energa's SCP continues to benefit from stable and predictable electricity distribution, which has lower business risk than conventional generation and supply. The regulatory framework in Poland is stable and has further improved following the introduction of a regulatory account in 2021, which allows for the automatic reflection of differences between actual and forecast distribution volumes with a two-year delay.

**Supply Potentially Under Pressure:** Energa's electricity supply business may come under pressure if the company is not allowed to fully pass on higher purchase costs of electricity to retail customers. The announced government measures (anti-inflation shield) provide for cuts in excise duty and VAT on electricity as well as a new state allowance for poorest households, mitigating the impact of electricity price increases for households.

However, more far-going measures like maximum electricity prices would likely be negative unless adequate compensations are paid to utilities for keeping prices low.

**Spin-Off of Coal-Fired Units:** The Polish government proposed spinning off a coal-fired power plant owned by Energa and the coal-fired power plants of its Polish peers to a fully state-owned entity, the National Agency for Energy Security (NABE). This should have a positive impact on Energa's credit profile, allowing the company to focus on electricity distribution and renewable generation, and improve its debt capacity. The deal is not yet binding and lacks important details such as the price to be paid by NABE and the amounts of debt to be transferred to NABE. Consequently we have not included it in our rating case.

## 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), ENEA S.A. (BBB/Stable) and TAURON Polska Energia S.A. (Tauron; BBB- /Stable).

All peers are rated on a standalone basis. Energa's and Tauron's business profiles benefit from the large share of regulated distribution in EBITDA, which provides good cash-flow visibility when conventional generation and mining are under pressure. Both companies' credit profiles are also supported by inflows from capacity payments which improve revenue visibility, although Tauron benefits from more significant amounts due to its larger size of coal-fired fleet. Nevertheless, Tauron has a greater share of hard-coal fired generation in business profile, which is currently under pressure. Tauron also controls a mining division, which has been loss-making since 2016 and has a

negative impact on credit risk. We assess that Energa has a more sustainable business profile, which is reflected in its higher debt capacity, with a negative rating sensitivity of 5.0x compared with 4.5x for Tauron.

PGE is the largest company and has the lowest leverage among 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 ENEA and Tauron. Rising CO2 prices could diminish this cost advantage if not accompanied by high hard coal prices, given the higher carbon footprint of lignite than hard coal. ENEA has a lower share of regulated distribution than Energa and Tauron and at the same time higher exposure to hard coal-fired generation, but controls a low-cost mining business.

## KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Weighted-average cost of capital in the distribution segment at 5.3% in 2021 and 5.8% in 2022-2025
- Ostroleka C switched to gas-fired with 50% plus one share ownership by Energa
- Capex and acquisitions at PLN15.2 billion in 2021-2025
- Flexible management of capex in case of weaker than expected results
- Continuation of a no-dividend policy

## RATING SENSITIVITIES

**Factors that could, individually or collectively, lead to positive rating action/upgrade:**

- Positive rating action on PKN ORLEN
- FFO net leverage below 4x on a sustained basis, would be positive for the SCP

**Factors that could, individually or collectively, lead to negative rating action/downgrade:**

- Negative rating action on PKN ORLEN
- FFO net leverage above 5x on a sustained basis, for example, due to a protracted economic downturn, higher than planned capex or reinstatement of dividends, would be negative for the SCP

PKN ORLEN's rating sensitivities from the last rating action commentary on 17 May 2021 are:

**Factors that could, individually or collectively, lead to positive rating action/upgrade:**

- Successful completion of the proposed merger with LOTOS and PGNiG combined with visibility on the group's wider strategic direction and financial policy coupled with FFO net leverage below 2.7x on a sustained basis

**Factors that could, individually or collectively, lead to negative rating action/downgrade:**

The rating is on RWP, therefore, we do not expect negative rating action at least in the short term. However, failure to complete the mergers, especially with PGNiG, or completion of the mergers or new financial policy leading to FFO net leverage above 2.7x on a sustained basis would lead to RWP removal and Stable Outlook.

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## LIQUIDITY AND DEBT STRUCTURE

**Adequate Liquidity:** At end-September 2021, Energa had PLN200 million of unrestricted cash and equivalents and PLN3.4 billion of committed unused credit lines against remaining debt maturities of PLN101 million in 2021 and PLN941 million in 2022 and Fitch-calculated negative free cash flow after acquisitions in the next 12 months from October 2021. In December 2021, the company signed a new credit agreement with European Investment Bank for EUR150 million.

## ISSUER PROFILE

Energa is an integrated utility operating in Poland. The main areas of operations are electricity distribution, electricity generation, as well as electricity supply. Energa's shares are listed in the Warsaw Stock Exchange, but a controlling shareholding is held by PKN ORLEN.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Energa is credit-linked to PKN ORLEN.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Energa S.A.	LT IDR    BBB- Rating Watch Positive	BBB- Rating Watch Positive
	Rating Watch Maintained	
	LC LT IDR    BBB- Rating Watch Positive	BBB- Rating Watch Positive
	Rating Watch Maintained	

	Natl LT	A(pol) Rating Watch Positive	A(pol) Rating Watch Positive
		Rating Watch Maintained	
senior unsecured	LT	BBB- Rating Watch Positive	BBB- Rating Watch Positive
		Rating Watch Maintained	
subordinated	LT	BB Rating Watch Positive	BB Rating Watch Positive
		Rating Watch Maintained	
senior unsecured	Natl LT	A(pol) Rating Watch Positive	A(pol) Rating Watch Positive
		Rating Watch Maintained	
Energa Finance AB (publ)			
senior unsecured	LT	BBB- Rating Watch Positive	BBB- Rating Watch Positive
		Rating Watch Maintained	

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**APPLICABLE CRITERIA**[Corporate Hybrids Treatment and Notching Criteria \(pub. 12 Nov 2020\)](#)[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)[Corporates Recovery Ratings and Instrument Ratings Criteria \(pub. 09 Apr 2021\) \(including rating assumption sensitivity\)](#)[Corporate Rating Criteria \(pub. 15 Oct 2021\) \(including rating assumption sensitivity\)](#)[Parent and Subsidiary Linkage Rating Criteria \(pub. 01 Dec 2021\)](#)**APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

[Corporate Monitoring & Forecasting Model \(COMFORT Model\), v7.9.0 \(1\)](#)**ADDITIONAL DISCLOSURES**[Solicitation Status](#)[Endorsement Policy](#)**ENDORSEMENT STATUS**

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