FitchRatings

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Fitch Affirms Energa at 'BBB+'; Outlook Stable

Fitch Ratings - Warsaw - 05 Dec 2023: Fitch Ratings has affirmed Energa S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+' with Stable Outlook. A full list of rating actions is below.

The affirmation reflects Fitch's unchanged view on the company under Fitch's Parent and Subsidiary Linkage (PSL) Rating Criteria, under which Fitch equalises Energa's rating with that of parent ORLEN S.A.

Energa's Standalone Credit Profile (SCP) remains at 'bbb-' and is supported by a solid business profile, with a focus on its predictable regulated electricity distribution business, and strong operational record. Its large capex plan will increase Energa's net leverage, which after peaking in 2025, should return to within our sensitivities in 2026 when its new generation units start contributing to EBITDA.

Key Rating Drivers

Distribution Supports Credit Profile: The ratings reflect a high share of regulated electricity distribution in Energa's EBITDA (on average 83% in 2021-2022 and 60% in 2023-2027), which indicates lower business risk and greater cash flow predictability than merchant power generation.

The higher weighted-average cost of capital (WACC) at 8.5% in 2023, up from 5.8% in 2022, is a primary driver of solid results in distribution in 2023, despite a decrease in the volume of distributed energy. We assume WACC to average 8.5% over the forecast period. We expect a large investment plan in the distribution grid to build up a regulated asset base, which, combined with increased WACC, will further strengthen EBITDA in this segment over the next four years.

Supply Driven by Regulations: Based on Fitch's projections, Energa is likely to post PLN1.2 billion of EBITDA in the supply segment in 2023, contrary to negative EBITDA last year. This is because in 2023 Energa has been gradually releasing a PLN1,068 million provision established in 2022 for a cap on energy prices for households, SME, local governments and utilities after receiving compensation from the state mechanism for the supply price cap.

However, we expect an adverse, uncompensated impact of around PLN320 million following further regulatory changes implemented in September 2023, which reduced bills for households (by PLN125 per household).

No Price Caps Assumed from 2024: Fitch assumes no price caps from 2024 under our rating case, and final settlements under the current compensation mechanism in the first months of 2024 to only temporarily increase working capital in 2023. However, if price caps are implemented in 2024 we assume a compensation mechanism will be put in place. Over 2023 there have been no delays in payments of compensation due to a monthly settlement mechanism.

During 9M23 Energa recognised extra costs related to contributions paid by the generation segment to the Price Difference Payment Fund of PLN924 million, and PLN3.2 billion of revenue from compensation for the electricity price freeze, relating mainly to the sales (85%) and distribution segments (15%).

Generation EBITDA to Normalise: Under Fitch's rating case we project Energa's EBITDA in the generation segment to reach PLN350 million in 2023, after an exceptionally strong EBITDA of PLN843 million in 2022. Weaker performance expected this year results from extra costs relating to the price cap for generators, higher coal prices in conventional generation and declining trend in generation volumes. We view the substantial share of quasi-regulated income from capacity payments and additional support for renewable assets as a factor driving the segment's profitability.

Conventional Generation Under Pressure: Over the long term, we expect deterioration in the profitability of coal-fired assets due to declining electricity prices and increasing CO2 costs, which will put clean dark spread under pressure. Under the rating case, Fitch assumes revenue from the capacity market will partly compensate worsened margins on electricity sales. We view conventional coal-fired assets as a burden on Energa's generation profitability until its two new combined heat and power units (CCGT) units in Ostroleka and Grudziadz are commissioned in 2026.

New CCGT to Boost Profits: We expect the new CCGT units to increase Energa's capacity by nearly 1.3 GWe in 2026. Both projects have signed 17-year capacity payments agreements, which will significantly improve the segment's result from 2026 and mitigate the plants' cash flow exposure to gas and CO2 prices.

Capex-Driven Leverage: Fitch projects Energa's funds from operations (FFO) net leverage to peak at 6.0x in 2025 following high capex and leading to a sharp increase of net debt. Capex plan includes investments in distribution and on strategic projects, including the construction of new CCGTs in Ostroleka and Grudziadz. The new CCGTs should contribute to EBITDA growth from 2026, leading to gradual reduction in Energa's leverage to about 4.1x in 2026-2027.

Hybrids Lose Equity Credit: Energa redeemed tranche A of its EUR125 million hybrid bonds in September 2023 under the first call option without refinancing it with a similar equity-like instrument. Fitch is revising its equity credit to zero from 50% for the remaining EUR125 million hybrid debt with a first call option in 2027, as we do not have sufficient assurance that hybrids will remain in the capital structure.

Energa has access to cash-pooling within the ORLEN group together with intercompany loans from its parent as the company moves to centralised funding for most of its new debt. Removal of equity credit increases Energa's FFO net leverage only by 0.1x.

Equalisation Rating Approach: We view ORLEN's SCP as stronger than Energa's due to its larger-scale operations, stronger business diversification and lower leverage. Applying the stronger parent/weaker subsidiary approach under our PSL Criteria, we equalise the rating of Energa with that of ORLEN. This is based on our reassessment of 'Medium' legal incentives, combined with 'High' strategic and operating incentives.

Derivation Summary

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

All peers are rated on a standalone basis. Energa's and Tauron's business profiles benefit from a 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 that improve revenue visibility, although Tauron benefits from more significant amounts due to its larger coal-fired fleet.

We believe 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 Tauron's 4.5x.

PGE is the largest integrated utility in Poland 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 a cost advantage over hard coal-fired peers such as ENEA and Tauron. However, rising CO_2 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:

- WACC in the distribution segment averaging 8.5% in 2023-2027

- Electricity prices on average at PLN607/MWh in 2023-2027

- CCGT Ostroleka operational from 2026, with 50% plus one share ownership by Energa

- Capex totaling about PLN18 billion in 2023-2025

- Continuation of a no-dividend policy

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Positive rating action on 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 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, which would be negative for the SCP

ORLEN's rating sensitivities from the most recent Rating Action Commentary on 9 November 2022 are:

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Rating upside is currently limited unless the business profile strengthens significantly with larger scale of operations and geographical diversification combined with lower execution risk in shifting the business towards lower-emission technologies

- Net debt/EBITDA below 1.5x or FFO net leverage below 1.7x on a sustained basis

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Net debt/EBITDA above 2.5x or FFO net leverage above 2.7x on a sustained basis

- Higher-than-expected variability of cash flow

- Aggressive financial policy with higher-than-expected dividend payments or debt-funded acquisitions

Liquidity and Debt Structure

Adequate Liquidity: At end-September 2023, Energa had PLN88 million of unrestricted cash and equivalents, and PLN3.8 billion of committed unused credit lines. This compared with short-term maturities of PLN2.2 billion, and about PLN4 billion Fitch-projected negative free cash flow in the next 12 months from October 2023.

We expect that ORLEN will continue to address Energa's short-term financing needs through intra-group loans, cash pooling, and revolving credit lines accordingly to current needs. Our rating case assumes additional external financing for distribution capex to be finalised in 1Q24.

Issuer Profile

Energa is an integrated utility operating in Poland. The main areas of operations are electricity distribution, generation and supply.

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 ORLEN.

ESG Considerations

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Energa S.A.	LT IDR	BBB+	Affirmed		BBB+
	LC LT IDR	BBB+	Affirmed		BBB+

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	Natl LT	AA+(pol)	Affirmed		AA+(pol)
• senior unsecured	LT	BBB+	Affirmed		BBB+
• subordinated	LT	BBB-	Affirmed		BBB-
• senior unsecured	Natl LT	AA+(pol)	Affirmed		AA+(pol)
Energa Finance AB (publ)					
• senior unsecured	LT	BBB+	Affirmed		BBB+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub.12 Nov 2020)

Corporate Rating Criteria (pub.03 Nov 2023) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.13 Oct 2023) (including rating assumption sensitivity)

National Scale Rating Criteria (pub.22 Dec 2020)

Parent and Subsidiary Linkage Rating Criteria (pub.16 Jun 2023)

Applicable Models

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Energa Finance AB (publ)	EU Issued, UK Endorsed
Energa S.A.	EU Issued, UK Endorsed

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