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Research Update:

Slovakian Energy Company Zapadoslovenska Energetika Upgraded To 'A-' On Sovereign Upgrade; Outlook Stable

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Overview

- In our view, Slovakian electricity distribution and supply company Zapadoslovenska energetika a.s. (ZSE), which is 51% state-owned, has a "moderately high" likelihood of extraordinary government support in the event of financial distress.
- We recently upgraded Slovakia and therefore believe that the government's ability to support ZSE has strengthened.
- We are therefore raising our long-term rating on ZSE to 'A-' from 'BBB+'.
- The stable outlook reflects our forecast of stable and predictable earnings from ZSE's relatively low-risk regulated distribution business, as well as financial metrics commensurate with our assessment of its "significant" financial risk profile.

Rating Action

On Aug. 4, 2015, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Slovakia-based, 51% state-owned electricity distribution and supply company Zapadoslovenska energetika a.s. (ZSE). The outlook is stable.

At the same time, we raised our issue rating on ZSE's senior unsecured debt to 'A-' from 'BBB+'.

Rationale

The upgrade follows the similar rating action we took on Slovakia, which we upgraded to 'A+' from 'A' on July 31 (see "Slovak Republic Long-Term Rating Raised To 'A+' On Accelerating Growth; Outlook Stable," published on RatingsDirect). We consider ZSE to be a government-related entity (GRE), and believe there is a "moderately high" likelihood that the Slovak government would provide extraordinary support to ZSE in the event of financial distress. We believe that the government's ability to support ZSE has strengthened.

We base our ratings on ZSE on its stand-alone credit profile (SACP), which we continue to assess at 'bbb+', reflecting our view of its "strong" business risk profile and "significant" financial risk profile. In accordance with our criteria for GREs, our view of a "moderately high" likelihood of extraordinary government support is based on our assessment of ZSE's:

- "Important" role as the monopoly provider of electricity distribution services and as the supplier of last resort in its service area of western Slovakia.
- "Strong" link with the Slovak government, which owns 51% of ZSE's shares through the Ministry of Economy. We base our view on our understanding that the government has no plans to privatize ZSE in the medium term and will continue to exercise control over ZSE's key strategic decisions on investments and financial policies.

Our assessment of ZSE's business risk profile as "strong" reflects the company's monopoly market position as the only electricity distribution operator in the relatively wealthy service area of western Slovakia. We assess country risk as "intermediate" based on ZSE's cash flows being entirely derived from the Slovak Republic.

We believe that the regulatory framework--supervised by the independent regulator RONI (Slovak Regulatory Office for Network Industries)--is supportive and transparent, ensuring high predictability of earnings through to the end of the current regulatory period in 2016.

In our view, ZSE's cash flow generation is strong, with EBITDA margins of about 60% (excluding pass-through costs for renewable energy generation). We view ZSE's profitability as comparable to its regulated peers in Western Europe, despite its regulatory framework allowing a relatively low cost of capital. Nevertheless, regulatory reset risk occurs every five years, with the next reset scheduled for 2017. In addition, the company has some exposure, albeit limited, to volume risk.

We view ZSE's supply business, which contributes about 10% of EBITDA on a normalized basis, as a negative credit factor. This is because of the supply business' inherent exposure to some merchant (price and demand) risk. We anticipate that competition and, consequently, ZSE's customer switching rates, will increase as the Slovak market is gradually liberalized. However, we do not expect price caps for residential customers and small enterprises to be abolished in the medium term. ZSE enjoys a dominant market position in its service area, a large and diversified customer base, and is gradually penetrating the gas supply market.

Our view of ZSE's financial risk profile as "significant" reflects its strong cash flow generation and limited investment requirements, which result in generally positive free operating cash flow (FOCF) after capital expenditures (capex). We project that ZSE's Standard & Poor's-adjusted funds from operations (FFO) to debt will exceed 20% in the medium term. We view the regulated distribution business as having relatively low volatility, but owing to the merchant risk associated with the supply business, we use the financial ratio benchmarks associated with a medial volatility industry in our analysis.

We forecast ZSE to achieve credit ratios at the upper end of the range for a "significant" financial risk profile. We therefore incorporate one notch of uplift in the rating under our positive comparable rating analysis modifier. We view management and governance as "satisfactory."

Liquidity

We assess ZSE's liquidity as "strong" under our criteria. This reflects our view that ZSE's liquidity sources will exceed its liquidity needs by at least 1.5x over the next 12 months, and by at least 1.0x over the next 24 months.

We estimate that ZSE's principal liquidity sources over the next 12 months comprise:

- Access to unrestricted short-term cash of about €90 million as of June 30, 2015;
- Undrawn committed credit facilities of €20 million and €55 million, both maturing in September 2018; and
- Our forecast that ZSE will generate about €130 million of adjusted FFO.

We estimate that ZSE's principal liquidity uses over the next 12 months comprise:

- No short-term debt maturities;
- About €70 million-€80 million of capital investments; and
- The distribution of all available cash flows as dividend payments.

ZSE's liquidity is supported by our forecast of strongly positive FOCF after capex. Furthermore, the company has two revolving credit facilities with terms of five years. We understand that ZSE's dividend policy aims to distribute all available cash flows, but it has some flexibility to maintain leverage below 3.2x.

We understand that the euro medium-term note program does not contain any covenants. At the same time, we see as a weakness that the company's liquidity credit facilities are subject to early repayment if the rating on ZSE falls to speculative grade. That said, we do not anticipate that ZSE will need to resort to these facilities. This is because in the normal course of its business, its cash flows more than adequately cover investment needs, and dividends are discretionary.

Outlook

The stable outlook on ZSE reflects the stable outlook on Slovakia. It also reflects our view of continued stable and predictable earnings and cash flows from what we see as ZSE's relatively low-risk regulated distribution business. We also anticipate that ZSE will maintain its dominant retail position in its service area and continue to acquire gas customers to offset any loss of electricity customers. We believe that adjusted FFO to debt above 20% is commensurate with the current SACP of 'bbb+'.

Downside scenario

We could lower the rating on ZSE if we take a similar action on Slovakia or if we revise downward ZSE's SACP by one notch, assuming our view on extraordinary state support for ZSE remains unchanged.

Pressure on ZSE's SACP could arise if its credit metrics weaken, in particular if adjusted FFO to debt falls below 20%. This could occur if ZSE's actual operating costs or capital investment costs are higher than the regulator allows. Higher customer turnover or the company's profit margin being lower than we anticipate due to fiercer competition in the Slovak electricity supply sector could also weigh on credit metrics. We could see adverse consequences for ZSE's FFO-to-debt ratio if the deficit resulting from payments to renewable energy generators is higher than we forecast, or is not compensated for under regulatory mechanisms in a timely manner. We could also revise downward ZSE's SACP if the company adopts more aggressive shareholder policies in terms of leverage tolerance or dividend payouts.

Upside scenario

We see an upgrade as unlikely at present because a higher rating on ZSE would require a three-notch upgrade of Slovakia or a two-notch upgrade of ZSE's SACP to 'a'. We could revise ZSE's SACP upward to 'a-' if the company is able to achieve and maintain adjusted FFO to debt of above 23%. According to our GRE methodology, a one-notch change in the SACP would not affect the corporate credit rating, all else being equal.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable—

Business risk: Strong
- Country risk: Intermediate
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Strong
- Management and governance: Satisfactory
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+
- Related government rating: A+
- Likelihood of government support: Moderately high (+1 notch from SACP)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Slovak Republic Long-Term Ratings Raised To 'A+' On Accelerating Growth; Outlook Stable, July 31, 2015

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Zapadoslovenska energetika a.s.		
Corporate Credit Rating	A-/Stable/--	BBB+/Positive/--
Senior Unsecured	A-	BBB+

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