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Research Update:

Slovak Utility Zapadoslovenska Energetika 'A-' Ratings Affirmed After Successful Refinancing; Outlook Stable

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Overview

- Slovak electricity utility Zapadoslovenska energetika a.s. (ZSE) successfully executed the refinancing of its €315 million debut bonds maturing in October 2018.
- At the same time, we expect that ZSE will continue to post solid financial performance over the next three years, fueled by strong economic prospects for Western Slovakia.
- Our view of ZSE's stand-alone creditworthiness has strengthened as a result.
- We are affirming our 'A-' issuer credit rating on ZSE. The likelihood of extraordinary support from the Slovak government to ZSE remains moderately high, but this no longer grants any rating uplift to ZSE.
- The outlook remains stable.

Rating Action

On March 14, 2018, S&P Global Ratings affirmed its long-term issuer credit rating on Slovakia-based electricity distribution and supply company Zapadoslovenska energetika a.s. (ZSE) at 'A-'. The outlook remains stable.

We also affirmed our 'A-' issue rating on ZSE's senior unsecured debt.

Rationale

The affirmation follows ZSE's successful refinancing of its €315 million debut bond maturing in October 2018, which has lowered the group's total debt costs. This refinancing, coupled with the strong prospects for ZSE's activities in its area of operation, will enhance the company's financial performance, in our view. As a result, we have revised upward our assessment of the company's stand-alone credit profile (SACP) to 'a-' from 'bbb+'. We continue to view the likelihood of extraordinary support to ZSE from Slovakia (A+/Stable/A-1) if needed as moderately high, but this no longer grants any rating uplift to ZSE given its higher SACP. We therefore affirmed the rating.

We consider that the refinancing of the €315 million bond illustrates ZSE's ability to tap the bond market at more favorable financing conditions. As a result, ZSE has managed to create a more comfortable debt maturity profile, with the weighted-average maturity of its debt instruments shifting to more than 7 years from 3.5. While the refinancing in itself has no significant impact on the company's financial risk profile, in our view, it allays our previous concerns regarding ZSE's large refinancing needs for October 2018 (about 50% of the previous total outstanding debt) against the backdrop of the execution risks that an untested refinancing process could carry.

Meanwhile, ZSE continues to benefit from its monopoly position as the electricity distribution system operator and a dominant position as the electricity supplier in the relatively wealthy service area of Western Slovakia. In 2017, ZSE derived around 94% of its EBITDA from its regulated activities (predominantly electricity distribution along with electricity and gas supply to households and small and midsize enterprises). The remaining 6% came from unregulated electricity and gas supply activities to midsize and large enterprises. We view the significant proportion of regulated revenues in ZSE's business mix as a supportive element for its financial metrics, generating a reliable source of stable and predictable cash flows. At year-end 2017, ZSE posted an adjusted EBITDA of €203 million and adjusted net debt of €554 million, which coincides with an adjusted FFO-to-debt ratio above 26%.

We have not materially revised our expectations compared to our previous base case. We continue to forecast that ZSE's distributed volumes will increase through to the end of the current regulatory period on the back of strong organic growth prospects and increased electricity consumption in Western Slovakia.

Our base case assumes:

- Continued regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2021).
- Pretax weighted-average cost of capital (WACC) set at 6.27% for 2018 and reset every year.
- Stable EBITDA till the end of the current regulatory period; 2018 EBITDA at the same level as 2017.
- The renewable support deficit is expected to be shifted to a dedicated central payer (OKTE), which will mitigate cash flow volatility. We assume no renewable support after 2019.
- Investment plan, supported by organic growth (mainly network enhancement projects), to increase from currently low levels of around €100 million.
- Substantial increase in dividend payout, although we understand there will be an element of discretion in order to maintain credit quality.

Based on our assumptions, we forecast the following credit measures:

- Funds from operations (FFO) to debt of 25% on average for the next two-to-three years;

- Positive free operating cash flow to debt to remain around 8%;
- Marginally negative discretionary cash flow to debt; and
- Debt to EBITDA of 2.8x-3.2x for the next two-to-three years.

Our view of the moderately high likelihood of extraordinary government support from Slovakia to ZSE if needed 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; and
- Strong link with the Slovak government, which owns 51% of ZSE's shares.

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.

Liquidity

We assess the company's liquidity as adequate. Qualitative factors that support this assessment include ZSE's solid relationships with banks; the company's high standing in credit markets; the ongoing benefit of its state ownership; and prudent financial policy. On this basis, we expect annual cash flow generation, the group's cash position, and committed credit facilities will cover expected cash outlays--mainly capital expenditure and dividends--by approximately 1.3x over the next 12 months. We also forecast that sources would cover uses even if EBITDA declined by 10%.

We anticipate the company will have the following principal liquidity sources over the next 12 months:

- Access to unrestricted short-term cash of about €95 million as of Dec. 31, 2017;
- Undrawn committed credit facilities of €20 million and €55 million both maturing in October 2023; and
- Our forecast that ZSE will generate approximately €130 million of adjusted FFO.

We anticipate the company will have the following principal liquidity uses over the same period:

- No short-term debt maturities following the full refinancing of the €315 million bond maturing in October 2018;
- About €90 million of capital investments; and
- Dividend payments of approximately €69 million.

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

Outlook

The stable outlook on ZSE 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.

Downside scenario

We could lower the rating on ZSE if we took a similar action on Slovakia and at the same time revised ZSE's SACP down by one notch, assuming our view of extraordinary state support for ZSE remained unchanged. We could also lower the rating if we revised the SACP down by two notches.

ZSE's SACP could come under strain if, for example, there were any unexpected negative changes to the regulatory framework, if the deficit resulting from payments to renewable energy generators were not compensated for under regulatory mechanisms in a timely manner, or if ZSE's operating costs or capital investment costs are higher than the regulator allows. We could also revise down the SACP if ZSE's credit metrics weakened, in particular if adjusted FFO to debt fell below 18% without any prospects for recovery. This could occur if the company adopted more aggressive shareholder policies in terms of leverage tolerance or dividend payouts.

Upside scenario

We see an upgrade as unlikely, at present. We could raise the rating on ZSE if we were to upgrade Slovakia, or if ZSE were to post an adjusted FFO to debt ratio sustainably above 28%, assuming our view of the likelihood of extraordinary government support remained unchanged.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/--

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: a-
- Sovereign rating: A+
- Likelihood of government support: Moderately high (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

ZSE's financial debt consists of senior unsecured debt at the parent level.

Analytical conclusions

The issue rating on ZSE's senior unsecured debt is 'A-', in line with the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013

- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Zapadoslovenska energetika a.s.	
Corporate Credit Rating	A-/Stable/--
Senior Unsecured	A-

Additional Contact:
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.