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Research Update:

Slovak Power Utility ZSE Ratings Affirmed At 'A-' Following Debt Refinancing; Outlook Stable

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Rating Action Overview

- We view ZSE's operating performance as solid and we assess that its liquidity has improved as a result of its debt refinancing and improved cash flow stability.
- We are affirming our 'A-' ratings on ZSE and its senior unsecured debt.
- The outlook is stable.

Rating Action Rationale

The affirmation follows the refinancing of 50% of ZSE's financial debt that was due in October 2018 (i.e. €315 million), as well as improved cash flow stability after 2019. As of 2020, Slovakian distribution system operators (DSOs) will no longer be the payer under the RES/CHP support system (for renewable and combined-heat-and-power generation). Any payment obligation for electricity feed-in by renewable and combined-heat-and-power generators is effectively shifted to a dedicated central payer, the Electricity Market Operator (OKTE). This is a positive development because any deficit between actual and assumed cost for electricity feed into the grid no longer needs to be advanced by ZSE. Due to a two-year delay in recovery of the deficit, the support mechanism has led to cash flow volatility for ZSE and an increased need for liquidity management.

As a result, we have revised our liquidity assessment for ZSE following the debt refinancing, which allowed the company to secure lower financing costs. The next capital market maturity is in four years (October 2023).

Meanwhile, ZSE continues to benefit from its monopoly position as the electricity DSO and a very strong position as the electricity supplier in the relatively wealthy service area of Western Slovakia. In 2018, 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 very supportive, generating a reliable source of stable and predictable cash flows, while serving over one million customers.

Our base-case scenario assumes adjusted funds from operations (FFO) to debt will remain at about 27% over 2019 and 2020, leaving ample headroom above our downside threshold of 18% for the current rating.

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.

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 very strong 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 down our SACP on ZSE by one notch, assuming our view of extraordinary state support for ZSE remained unchanged. We could also lower the rating if we revised down the SACP by two notches.

ZSE's SACP could come under strain if, for example, there were unexpected negative changes to the regulatory framework, if the deficit resulting from payments to renewable energy generators were not compensated under regulatory mechanisms in a timely manner, or if ZSE's operating costs or capital investment costs were 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, because of ZSE's highly stable cash flow profile in conjunction with the company's financial policy. 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.

Company Description

ZSE is the sole DSO in the relatively wealthy service area of Western Slovakia and also has a very strong position as electricity supplier in the region.

In 2017, ZSE distributed 9.7 TWh (9.9TWh in 2018) of electricity throughout Western Slovakia and represented 27% of the power supply and 5% of gas supply in the whole country.

The Slovak Republic owns 51% of the company, while the remaining 49% is owned by E.ON.

Our Base-Case Scenario

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 in December 2021.
- Pretax weighted-average cost of capital (WACC) set at 6.04% for 2019 and reset every year (6.27% 2018).
- The renewable support mechanism will be shifted to a dedicated central payer (OKTE) from DSOs from 2020, while the residual deficit at ZSE will be settled over 2020-2023, which will mitigate ZSE's cash flow volatility.
- ZSE's investment plan (mainly network enhancement projects and renewable connections), to increase to about €120 million annually as of 2020 from currently low levels of around €90 million annually.
- No integration of ZSE and VSE assumed in our base case. We consider ZSE on stand-alone basis.
- A dividend payout ratio of about 100%, but could be lower, if needed to support the current rating or liquidity.

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

- FFO to debt of about 27% for the next two to three years;
- Positive free operating cash flow;
- Marginally negative discretionary cash flow; and
- Debt to EBITDA of 2.3x-2.6x for the next two to three years.

Liquidity

We assess the company's liquidity as strong. ZSE has solid relationships with banks, while the refinancing demonstrates the company's high standing in credit markets. Its reputation is further enhanced by the ongoing benefit of its state ownership and its prudent financial policy.

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 1.7x over the next 12 months and by 1.46x in the subsequent 12 months. We also forecast that sources would cover uses even if EBITDA declined by 30% in the coming 12 months, however, not in the subsequent 12 months.

We anticipate the company will have the following principal liquidity sources over the next 24 months:

- Access to unrestricted short-term cash of about €44 million as of Dec. 31, 2018;
- Undrawn committed credit facilities of €20 million and €55 million both maturing in October 2023; and
- Our forecast that ZSE will generate €170 million-€180 million of cash FFO annually.

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

- No debt maturities in next 24 months (next debt maturity in October 2023);
- Working capital outflows of €17 million;
- About €94 million of capital investments; and
- Dividend payments of approximately €62 million in 2019 and €74 million the year after.

Covenants

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.

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.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/--

Business risk: Strong

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

Financial risk: Intermediate (Medial volatility table)
- Cash flow/Leverage: Intermediate

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (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)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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 | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

Related Criteria

- E.ON To Be Bigger, Stronger, And More Flexible After 2020, Says Report, Jan. 16, 2019

Ratings List

Ratings Affirmed

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

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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 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.