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Zapadoslovenska energetika a.s.

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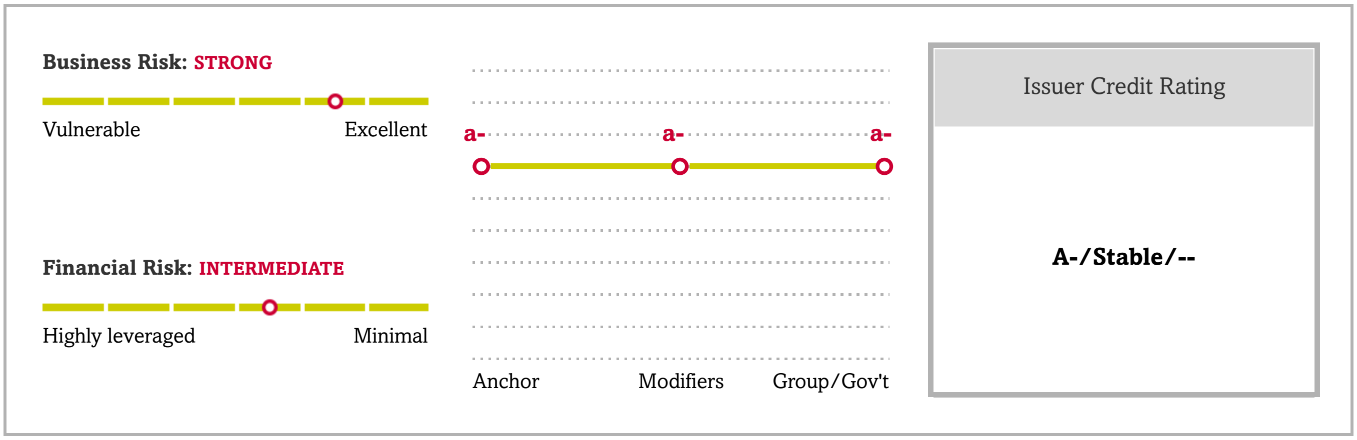


Credit Highlights

Overview

Key strengths	Key risks
Monopoly market position as the only electricity distribution operator in Western Slovakia, the largest of three in the country	Unregulated retail activities exposed to competition and merchant risk (below 10% of EBITDA)
The vast majority (90%) of cash flows coming from stable and predictable, via low-risk regulated distribution network operations	A relatively lumpy maturity profile (two bonds, one maturing every five years: October 2023 and March 2028) and aggressive dividend policy (an approximately 100% payout ratio)

Zapadoslovenska energetika a.s. (ZSE), as per its almost fully regulated utility activities, is better insulated from the market downturn than unregulated utilities or entities from other sectors in Central and Eastern Europe, amid heightened risks. S&P Global Ratings views the utility's Western Slovakia regulated electricity activities (more than 90% of its total) as under a relatively solid regulatory framework and reasonably protected against market downturns, because potential deviation from expected distribution volumes should have a timing impact on regulated cash inflow only. However, the macroeconomic effects of COVID-19 and the oil price shock have increased risks for ZSE. We believed regulated activities are exposed to somewhat heightening risk for policymakers deciding to introduce social tariffs or implementing some form of re-regulation. We do not see any indication thereof and consider radical policy shifts as unlikely; however, we note corruption and the business environment stand as ongoing major issue that weaken Slovakia's institutions (for more information, see the analysis on the country published Jan. 24, 2020, on RatingsDirect). Operationally, we observe most utilities, including ZSE, have developed contingency plans to manage pandemic disruptions and protect critical infrastructure.

Cash flow stability will improve on the lifting of requirements for renewable support subsidies from Slovak distribution system operators (DSOs). As of January 2020, the DSOs will no longer be obligated to pay upfront remuneration on electricity feed-in from renewable and combined heat and power (CHP) generation. We expect that this will lead to increased stability of cash flow over the years, as the volatile nature of electricity feed into the grid has led to some cash flow volatility for ZSE under the scheme. We expect the state budget to cover ZSE's most recent deficits (from 2018 and 2019) of about €43 million over the next two-to-three years.

The E.ON-RWE asset swap is credit neutral. E.ON and RWE concluded their asset swap (see "German Utility E. ON SE 'BBB/A-2' Ratings Affirmed Following Asset Swap Progress; Outlook Remains Stable," published March 26, 2020). We do not expect any implications for ZSE stemming from the ongoing integration of innogy into the group, as we understand there is no change to strategy or management envisaged.

Outlook: Stable

The stable outlook reflects our forecast 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 the utility will maintain its very strong retail supply position in its service area.

Downside scenario

We could lower the rating on ZSE if we took a similar rating action on Slovakia (A+/Stable/A-1) and revised down the utility's stand-alone credit profile (SACP) one notch, assuming our view of extraordinary state support for ZSE does not change. We could also lower the rating if we revised the SACP down by two notches.

We could consider revising the SACP if, for example, there were unexpected negative changes to the regulatory framework, the deficit resulting from payments to renewable energy generators were not compensated under regulatory mechanisms in a timely manner, or ZSE's operating or capital investment costs were higher than the regulator allows. We could also revise down the SACP if the utility's credit metrics weakened, in particular if adjusted funds from operations (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, 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 did not change.

Our Base-Case Scenario

Assumptions

- Continued regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2021)
- Pre-tax weighted-average cost of capital set at 5.81% for 2020 and reset every year (6.04% in 2019)
- The renewable support mechanism shifts to a dedicated central payer from DSOs in 2020
- The residual ZSE deficit will be settled over next two-to-three years , which will mitigate cash flow volatility
- No additional Renewable Energy Systems (RES) and CHP deficit from January 2020 onward
- Investment plan, supported by organic growth (mainly network enhancement projects and connections), to increase

to about €130 million, €110 million, and €125 million in 2020, 2021, and 2022, respectively, compared with about €105 million annually currently

- Dividend payout of about 100%, although this is flexible according to rating and liquidity considerations
- Average cost of debt of 2.6% over 2020-2022

Key Metrics

Zapadoslovenska energetika a.s.--Key Metrics*			
	--Fiscal year ended Dec. 31--		
(mil. €)	**2019a**	**2020e**	**2021f**
EBITDA	238	210-220	220-230
Debt	587	600-630	610-650
Capex	118	120-130	100-120
FFO/debt (%)	35	24-28	24-29

*S&P Global Ratings-adjusted figures. Capex--Capital expenditure. FFO--Funds from operations. a--Actual. e--Estimate. f--Forecast.

Company Description

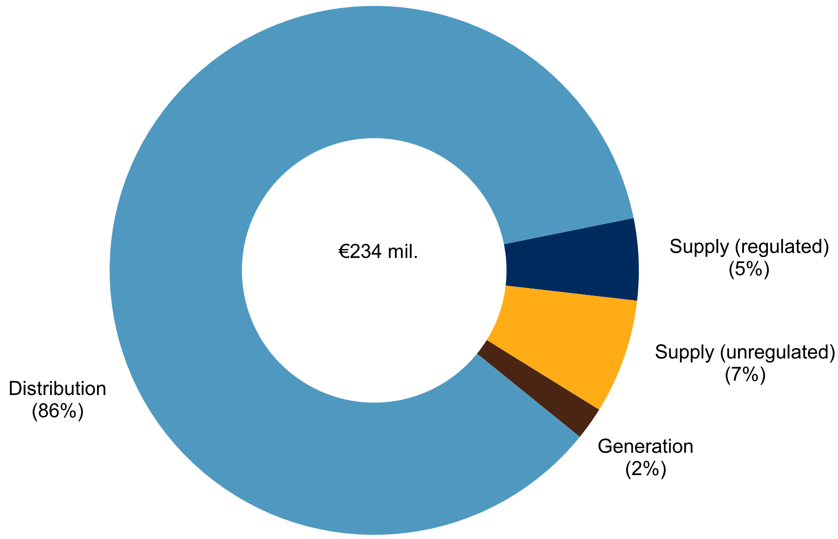
ZSE is the sole DSO in the relatively wealthy service area of Western Slovakia and also has a very strong position as electricity supplier in the region. It is the largest of three regional DSO providers in the country (ZSE, Stredoslovenska energetika (SSE), and Vychodoslovenska Energetika [VSE]). E.ON holds 49% of the shares in ZSE, the Western Slovakia distribution company; EP Infrastructure holds 49% of the shares in SSE, the distribution company operating in Central Slovakia; and RWE holds 49% of the shares in VSE, the Eastern Slovakia distribution company. The remaining shares at each DSO are held by the state.

In 2018, ZSE distributed 9.9 terawatt-hours (TWh; compared with 9.8 TWh in 2019) of electricity throughout Western Slovakia and represented 29% of the power (about 6.0 TWh) and 5% of the gas supply (2.7 TWh) in the country.

At year-end 2019, ZSE posted EBITDA (see chart 1) of €234 million (S&P Global Ratings-adjusted: €238 million) and financial debt of €572 million (S&P Global Ratings-adjusted: €587 million), which leads to an S&P Global Ratings-adjusted FFO-to-debt ratio above 34.9%.

Chart 1

Zapadoslovenska energetika a.s.--Fiscal 2019 EBITDA Split



Source: Company data.

Peer Comparison

Table 1

Zapadoslovenska energetika a.s.--Peer Comparison

Industry sector: Electric

	Zapadoslovenska energetika a.s.	Electricity Supply Board	Alliander N.V.	Electricity North West Ltd.	CEZ a.s.
Ratings as of June 18, 2020	A-/Stable/--	A-/Stable/A-2	AA-/Stable/A-1+	BBB+/Stable/A-2	A-/Negative/(A-2)
	--Fiscal year ended--				
	Dec. 31, 2019	Dec. 31, 2019	Dec. 31, 2018	March 31, 2019	Dec. 31, 2019
Currency (mil.)	€	€	€	£	CZK
Revenue	1,277.3	3,641.0	1,930.0	540.6	7,937.3
EBITDA	238.4	1,368.3	757.0	356.9	2,196.2
Funds from operations (FFO)	204.6	1,124.3	648.0	226.0	1,809.8
Interest expense	19.2	198.7	54.1	112.6	248.5
Cash interest paid	17.2	193.5	52.0	105.9	223.7

Table 1

Zapadoslovenska energetika a.s.--Peer Comparison (cont.)					
Cash flow from operations	223.3	938.3	634.0	185.2	1,678.5
Capital expenditure	118.1	804.2	710.0	269.5	1,162.0
Free operating cash flow (FOCF)	105.2	134.1	(76.0)	(84.4)	516.4
Discretionary cash flow (DCF)	41.4	86.6	(230.0)	(97.7)	10.0
Cash and short-term investments	82.2	125.1	152.0	52.8	383.8
Debt	586.9	6,013.4	2,257.0	1,869.6	8,518.6
Equity	155.5	3,895.2	3,976.0	919.5	10,045.0
Adjusted ratios					
EBITDA margin (%)	18.7	37.6	39.2	66.0	27.7
Return on capital (%)	25.4	6.4	6.3	8.1	5.1
EBITDA interest coverage (x)	12.4	6.9	14.0	3.2	8.8
FFO cash interest coverage (x)	12.9	6.8	13.5	3.1	9.1
Debt/EBITDA (x)	2.5	4.4	3.0	5.2	3.9
FFO/debt (%)	34.9	18.7	28.7	12.1	21.2
Cash flow from operations/debt (%)	38.0	15.6	28.1	9.9	19.7
FOCF/debt (%)	17.9	2.2	(3.4)	(4.5)	6.1
DCF/debt (%)	7.1	1.4	(10.2)	(5.2)	0.1

CZK--Czech koruna.

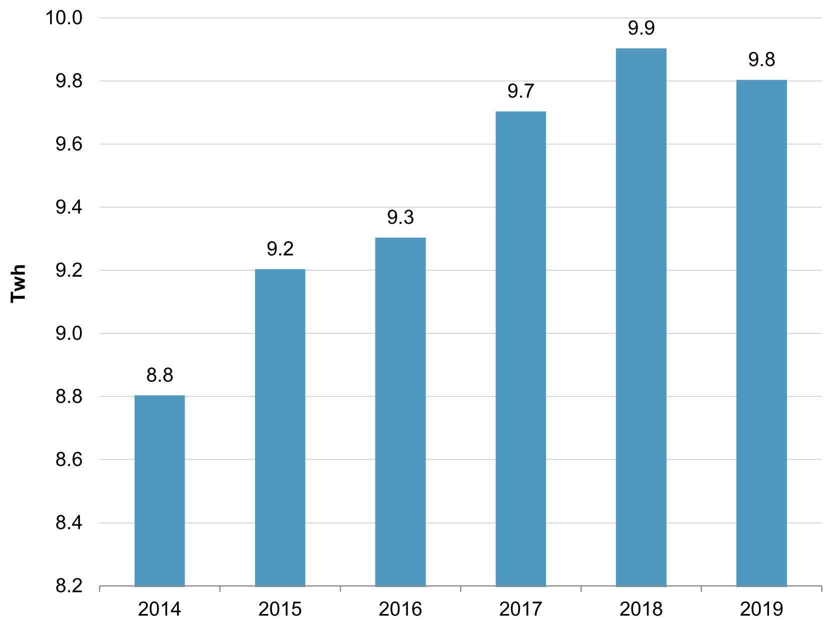
Business Risk: Strong

ZSE continues to benefit from its monopoly position as the electricity DSO and very strong market position as the electricity supplier in Western Slovakia. In 2019, the utility derived above 90% 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 share 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, generating a reliable source of stable and predictable cash flows, while serving over 1 million customers. We believe the regulatory framework--supervised by the independent regulator, Slovak Regulatory Office for Network Industries--is supportive and transparent, ensuring high predictability of earnings. We view ZSE's supply business as a negative credit factor because of its inherent exposure to merchant (price and demand) risk.

Chart 2

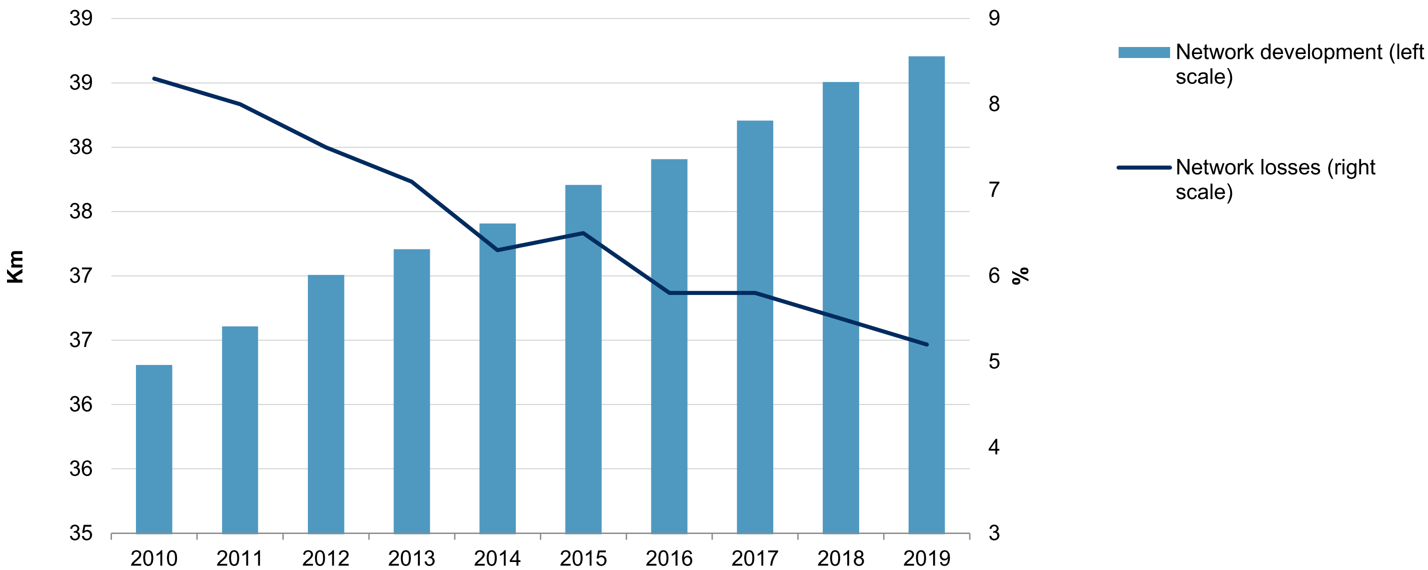
Zapadoslovenska energetika a.s.--Stable Distribution Volume



Source: S&P Global Ratings. TWh--Terawatt-hour.

Chart 3

Reduced Network Losses And Stable Growth In New Connections



km--Kilometer. Source: S&P Global Ratings.

Financial Risk: Intermediate

Our base-case scenario for the utility assumes adjusted FFO to debt to remain above 25% over 2020 and 2021, leaving ample headroom to our downside threshold of 18% for the rating.

We note positively ZSE's limited investment requirements, which result in generally positive free operating cash flow after capital expenditure. 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.

ZSE is exposed to some degree of refinancing risk through its uneven maturity profile. Some 50% of debt matures every five years.

The company's financial policy follows a 100% dividend payout ratio, but it is flexible if necessary to maintain the current rating and liquidity position.

Financial summary

Table 2

Zapadoslovenska energetika a.s.--Financial Summary

Industry sector: Electric

	--Fiscal year ended Dec. 31--				
	2019	**2018**	**2017**	**2016**	**2015**
(Mil. €)					
Revenue	1,277.3	1,124.5	1,065.0	1,001.3	1,009.0
EBITDA	238.4	206.8	202.8	197.7	189.3
Funds from operations (FFO)	204.6	145.5	144.8	155.3	145.6
Interest expense	19.2	26.2	23.4	26.0	24.0
Cash interest paid	17.2	22.5	22.3	22.4	22.4
Cash flow from operations	223.3	112.0	127.2	171.9	144.8
Capital expenditure	118.1	80.0	60.9	67.4	80.3
Free operating cash flow (FOCF)	105.2	32.1	66.3	104.5	64.5
Discretionary cash flow (DCF)	41.4	(38.4)	15.8	46.9	3.6
Cash and short-term investments	82.2	43.7	95.3	80.6	34.5
Gross available cash	82.2	43.7	95.3	80.6	34.5
Debt	586.9	608.8	552.5	568.6	615.9
Equity	155.5	79.6	50.2	3.1	(39.0)
Adjusted ratios					
EBITDA margin (%)	18.7	18.4	19.0	19.7	18.8
Return on capital (%)	25.4	24.1	25.9	25.6	24.9
EBITDA interest coverage (x)	12.4	7.9	8.7	7.6	7.9
FFO cash interest coverage (x)	12.9	7.5	7.5	7.9	7.5
Debt/EBITDA (x)	2.5	2.9	2.7	2.9	3.3
FFO/debt (%)	34.9	23.9	26.2	27.3	23.6
Cash flow from operations/debt (%)	38.0	18.4	23.0	30.2	23.5
FOCF/debt (%)	17.9	5.3	12.0	18.4	10.5
DCF/debt (%)	7.1	(6.3)	2.9	8.3	0.6

Reconciliation

Table 3

Zapadoslovenska energetika a.s.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (mil. €)

	--Fiscal year ended Dec. 31, 2019--							
Zapadoslovenska energetika a.s. reported amounts								
	Debt	**Revenue**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
	634.2	1,284.8	234.3	177.2	17.4	238.4	232.2	127.3
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(16.5)	--	--
Cash interest paid	--	--	--	--	--	(17.2)	--	--

Table 3

Zapadoslovenska energetika a.s.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (mil. €) (cont.)								
Reported lease liabilities	26.1	--	--	--	--	--	--	--
Postemployment benefit obligations/deferred compensation	8.8	--	0.1	0.1	0.1	--	--	--
Accessible cash and liquid investments	(82.2)	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	1.7	--	--	--
Dividends received from equity investments	--	--	0.3	--	--	--	--	--
Income (expense) of unconsolidated companies	--	--	(0.3)	--	--	--	--	--
Nonoperating income (expense)	--	--	--	0.0	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	0.3	--
Revenue: Other	--	(7.5)	(7.5)	(7.5)	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(0.3)	(0.3)	--	--	--	--
EBITDA: Other	--	--	11.8	11.8	--	--	--	--
Operating cash flow: Other	--	--	--	--	--	--	(9.2)	--
Capital expenditure: Other	--	--	--	--	--	--	--	(9.2)
Total adjustments	(47.3)	(7.5)	4.2	4.2	1.8	(33.8)	(8.9)	(9.2)
S&P Global Ratings' adjusted amounts								
	Debt	**Revenue**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
Adjusted	586.9	1,277.3	238.4	181.4	19.2	204.6	223.3	118.1

Liquidity: Strong

We assess the company's liquidity as strong. ZSE has solid relationships with banks, and refinancing of €315 million in debt in 2018 demonstrated the company's high standing in credit markets. ZSE's reputation is further enhanced by the ongoing benefit of its state ownership and prudent financial policy. On this basis, we expect annual cash flow, the group's cash position, and committed credit facilities will cover expected cash outlays--mainly capital expenditure and dividends--by above 1.7x over the next 12 months and by above 1.0x in the subsequent 12 months. We also forecast that sources would cover uses even if EBITDA declined by 30% in the 12 months from March 31, 2020.

Principal Liquidity Sources	Principal Liquidity Uses
We anticipate the company will have the following principal liquidity sources over the 24 months started March 31, 2020:	We anticipate the company will have the following principal liquidity uses over the same period: • No debt maturities in next 24 months (the next debt

- Access to unrestricted short-term cash of about €87 million
- Undrawn committed credit facilities of €75 million maturing in October 2023
- Our forecast that ZSE will generate about €170 million of cash FFO annually

maturity is in October 2023)

- About €239 million of total capital investments over the coming two years
- Dividend payments of approximately €74 million in 2020

Covenant Analysis

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

Government Influence

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 the company'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 the company's key strategic decisions on investments and financial policies.

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 the debt is 'A-', in line with the issuer credit rating, because 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

- **Cash flow/leverage:** Intermediate

Anchor: a-

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : a-

- **Related government rating:** A+
- **Likelihood of government support:** Moderately high (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- 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
- 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 Research

- The Energy Transition And What It Means For European Power Prices And Producers: Midyear 2020 Update, June 8, 2020
- The EU's Drive For Carbon Neutrality By 2050 Is Undeterred By COVID-19, April 29, 2020
- Credit Conditions In Europe Darken As Costs Of Lockdowns Add Up, April 27, 2020
- Recent Rating Reviews On EMEA Utilities Reflect The Sector's Strength Against COVID-19 Shock, April 7, 2020
- Worsening Credit Conditions In Locked-Down Europe Test Business, Governments, And The Eurozone, Report Says, April 1, 2020
- Research Update: German Utility E. ON SE 'BBB/A-2' Ratings Affirmed Following Asset Swap Progress; Outlook Remains Stable, March 26, 2020
- Shareholder Activism Does Companies' Credit Quality More Harm Than Good, March 25, 2020
- EMEA Utilities Should Withstand COVID-19 Better Than Most Sectors, March 24, 2020
- ESG Industry Report Card: Regulated Utilities Networks, Feb. 11, 2020
- ESG Industry Report Card: Power Generation, Feb. 11, 2020
- Slovakia, Jan. 24, 2020
- EMEA Utilities: Slides From The 2019 Infrastructure Roadshow, Dec. 5, 2019
- Five Issues To Keep An Eye On For European Utilities' Credit Quality, Dec. 5, 2019
- Industry Top Trends 2020: EMEA Regulated Utilities, Nov. 13, 2019
- Industry Top Trends 2020: EMEA Unregulated Utilities, Nov. 13, 2019
- Research Update: Slovak Power Utility ZSE Ratings Affirmed At 'A-' Following Debt Refinancing; Outlook Stable, April 11, 2019
- Slovakia Ratings Affirmed At 'A+/A-1'; Outlook Stable, Jan. 25, 2019
- E.ON After 2020: Bigger, Stronger, And More Flexible, Jan. 16, 2019

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	**a-/bbb+**	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of July 8, 2020)*

Zapadoslovenska energetika a.s.	
Issuer Credit Rating	A-/Stable/--
Senior Unsecured	A-
Issuer Credit Ratings History	
04-Aug-2015	A-/Stable/--
07-Aug-2014	BBB+/Positive/--
25-Sep-2013	BBB+/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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