S&P Global
Ratings

# RatingsDirect®

# Zapadoslovenska energetika a.s.

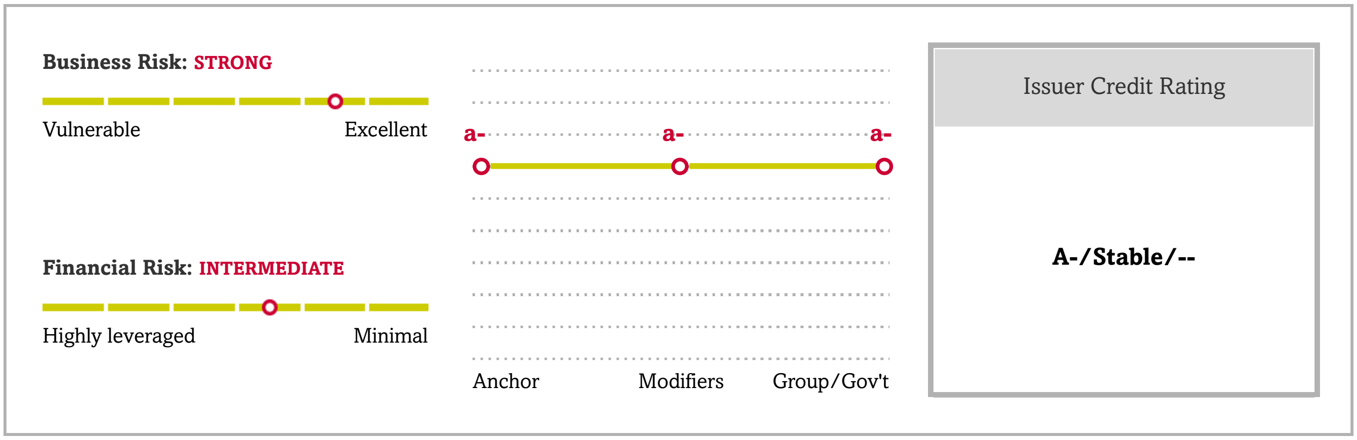
**Primary Credit Analyst:**
Bjoern Schurich, Frankfurt + 49 693 399 9237; bjoern.schurich@spglobal.com

**Secondary Contacts:**
Renata Gottliebova, Dublin + 00353 (1) 5680608; renata.gottliebova@spglobal.com
Elena Anankina, CFA, Moscow + 7 49 5783 4130; elena.anankina@spglobal.com
Per Karlsson, Stockholm + 46 84 40 5927; per.karlsson@spglobal.com

## Table Of Contents

## Table Of Contents (cont.)

# Zapadoslovenska energetika a.s.




## 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 (about 50% of total volume distributed by the three). | Unregulated retail activities exposed to competition and merchant risk (below 10% of EBITDA). |
| The vast majority (above 90%) of cash flows coming from stable and predictable, low-risk regulated distribution network operations. | A relatively lumpy maturity profile (two bonds, one maturing October 2023 and one March 2028) and aggressive dividend policy (an approximately 100% payout ratio). |
| Flexible dividend policy to support rating and liquidity. | Regulatory reset risk after 2022. |

***Regulated utility company Zapadoslovenska energetika a.s. (ZSE) proved fairly shielded to the COVID-19-driven market downturn.*** The company's Western Slovakia regulated electricity activities (more than 90% of its total EBITDA, excluding noncore operations at the Malzenice gas plant) under a supportive regulatory framework (for more information, see "Slovakia's Electricity And Gas Regulatory Framework: Supportive," published Oct. 6, 2020, on RatingsDirect) have been relatively resilient in market downturns, because potential deviation from expected regulated distribution volumes have a two-year timing impact on regulated cash inflow only plus distribution margins are largely linked to capacity payments, not wheeling volumes. We estimate the impact to be about €6 million. In 2020, ZSE experienced about 4% lower power supply volumes in its unregulated supply business, resulting in some losses due to selling of previously procured electricity at lower prices. We understand the impact is marginal. Furthermore, ZSE has not seen additional bad debt and we did not observe radical Slovak policy shifts such as policymakers introducing social tariffs or implementing some form of reregulation.

***Cash flow stability is driven by a predictable and supportive regulatory framework, albeit regulatory reset risk is increasing because the next reset is in 2023.*** S&P Global Ratings regards the regulatory framework as supportive and transparent, ensuring highly predictable earnings for operators over the 2017-2021 regulatory period. The period has been extended by one year and will reset following 2022. We are unclear on regulated earnings beyond that timeframe. However, we expect the regulator to reasonably lower the weighted-average cost of capital (WACC) allowance as per the track record of the framework to allow for sufficient financial support (for instance, 2017 increase in tariffs despite the Slovak government's strong opposition). Furthermore, we consider potential remedy measures by ZSE mitigating factors. Aside from the five-year regulatory resets, every year, the Slovak Regulatory Office for Network Industries (RONI) sets and publishes the WACC at the end of June, based on publicly disclosed parameters: for the year 2022 RONI lowered the pre-tax WACC to 4.36% from 5.65%. Our base-case scenario reflects the impact.

***ZSE's investment program focuses on regulated distribution assets, which should support its business risk profile.*** The regulated asset base (RAB) and regulated revenue will continue to grow given planned increased investment to €140 million-€150 million annually in 2021 and 2022 (compared with €120 million in 2019 and 2020). ZSE continues to finance its investments by operating cash flow, so we expect RAB continue to grow without exerting pressure on key credit metrics. Investments include two smart grid projects as European Projects of Common Interest (ACON and InGrid).

**Outlook: Stable**

The stable outlook reflects our forecast of continued stable and predictable earnings and cash flow 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--at the same time--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

- Regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2022). We lack regulatory visibility beyond then, but expect moderate adjustment on regulatory variables sufficient for the rating.
- Pretax WACC set at 5.65% for 2021 and 4.36% for 2022 (5.81% in 2020).

- The renewable support mechanism shifted to a dedicated central payer from distribution system operators (DSOs) from 2020.
- The unsettled 2019 Renewable Energy Systems (RES) deficit of €21 million to be collected over four years (2022-2025).
- No additional RES and combined heat and power deficit accumulated following January 2020.
- We do not consider any earnings contribution by noncore operations of the 436-megawatt Malzenice combined-cycle gas turbine power plant.
- Investment plan, supported by organic growth (mainly network enhancement projects and connections), to increase to €140 million-€150 million for 2020 and 2021.
- Dividend payout of about 100%, although this is flexible according to rating and liquidity considerations.
- Average cost of debt of 2.6% over 2021-2022.
- No mergers or acquisitions.

### Key metrics

**Zapadoslovenska energetika a.s.--Key Metrics***

| | --Fiscal year end Dec. 31-- | | | |
|---|---|---|---|---|
| **(Mil. €)** | **2019a** | **2020a** | **2021e§** | **2022e§** |
| EBITDA | 245.9 | 256.9 | 220-230 | 220-230 |
| Capital expenditure | 125.6 | 125.0 | 130-140 | 140--150 |
| Debt | 586.9 | 586.9 | 600-630 | 630-660 |
| FFO/debt (%) | 35.8 | 35.7 | 27-29 | 27-29 |

*All figures adjusted by S&P Global Ratings. §Excluding noncore operations from the Malženice gas plant. FFO--Funds from operations. a--Actual. e--Estimate.

## Company Description

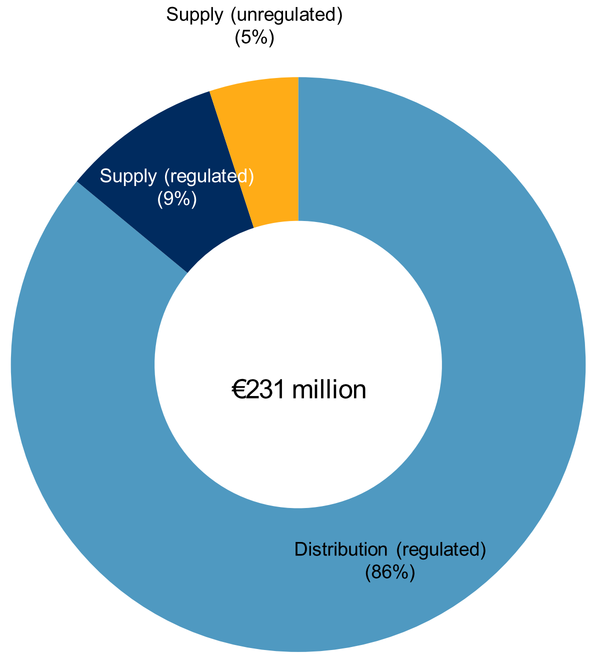
ZSE is the sole DSO in the relatively wealthy service area of Western Slovakia and also has a very strong position as electricity supplier in the region. It is the largest of three regional DSO providers in the country (ZSE, Stredoslovenska energetika [SSE], and Vychodoslovenska Energetika [VSE]). E.ON 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 E.ON AG holds 49% of the shares in VSE, the Eastern Slovakia distribution company. The remaining shares at each DSO are held by the state. Although ZSE is 51% state-controlled, the company's operations and strategy are sufficiently autonomous.

In 2020, ZSE distributed 9.4 terawatt-hours (TWh; compared with 9.8 TWh in 2019) of electricity throughout Western Slovakia and represented 29% of the power (about 6 TWh) and 5% of the gas supply (3 TWh) in the country.

At year-end 2020, ZSE posted EBITDA (see chart 1) of €231 million excluding generation from Malzenice (S&P Global Ratings-adjusted: €257 million) and financial debt of €634.7 million (S&P Global Ratings-adjusted: €587 million), which leads to an S&P Global Ratings-adjusted FFO-to-debt ratio of about 35.7%.

**Chart 1**

**Zapadoslovenska energetika a.s.--EBITDA Split, Fiscal 2020**




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. | CEZ a.s. | Electricity North West Ltd. |
|---|---|---|---|---|---|
| Ratings as of Aug. 11, 2021 | A-/Stable/-- | A-/Stable/A-2 | AA-/Watch Neg/A-1+ | A-/Stable/-- | BBB+/Stable/A-2 |
| | --Fiscal year ended-- | | | | |
| | Dec. 31, 2020 | | | | March 31, 2021 |
| **(Mil. €)** | | | | | |
| Revenue | 1,210.8 | 3,653.1 | 2,009.0 | 7,978.4 | 521.7 |
| EBITDA | 256.9 | 1,354.4 | 707.0 | 2,874.3 | 335.7 |
| Funds from operations (FFO) | 209.7 | 1,088.3 | 614.0 | 2,505.9 | 217.1 |
| Interest expense | 19.2 | 168.4 | 44.1 | 226.3 | 109.5 |
| Cash interest paid | 18.6 | 184.3 | 42.0 | 225.7 | 91.9 |
| Cash flow from operations | 202.7 | 1,005.2 | 630.0 | 2,737.1 | 195.7 |

**Table 1**

**Zapadoslovenska energetika a.s.--Peer Comparison (cont.)**

**Industry sector: Electric**

| | Zapadoslovenska energetika a.s. | Electricity Supply Board | Alliander N.V. | CEZ a.s. | Electricity North West Ltd. |
|---|---|---|---|---|---|
| Capital expenditure | 125.0 | 881.1 | 715.0 | 1,191.1 | 185.6 |
| Free operating cash flow (FOCF) | 77.7 | 124.1 | (85.0) | 1,546.0 | 10.1 |
| Discretionary cash flow (DCF) | 3.5 | 65.4 | (203.0) | 855.3 | (46.1) |
| Cash and short-term investments | 82.6 | 248.7 | 297.0 | 335.8 | 405.0 |
| Debt | 586.9 | 5,820.6 | 2,542.0 | 8,030.5 | 2,117.0 |
| Equity | 217.4 | 3,908.1 | 4,080.5 | 9,084.2 | 796.7 |
| Adjusted ratios | | | | | |
| EBITDA margin (%) | 21.2 | 37.1 | 35.2 | 36.0 | 64.3 |
| Return on capital (%) | 25.1 | 6.4 | 5.0 | 9.5 | 6.5 |
| EBITDA interest coverage (x) | 13.4 | 8.0 | 16.0 | 12.7 | 3.1 |
| FFO cash interest coverage (x) | 12.3 | 6.9 | 15.6 | 12.1 | 3.4 |
| Debt/EBITDA (x) | 2.3 | 4.3 | 3.6 | 2.8 | 6.3 |
| FFO/debt (%) | 35.7 | 18.7 | 24.2 | 31.2 | 10.3 |
| Cash flow from operations/debt (%) | 34.5 | 17.3 | 24.8 | 34.1 | 9.2 |
| FOCF/debt (%) | 13.2 | 2.1 | (3.3) | 19.3 | 0.5 |
| DCF/debt (%) | 0.6 | 1.1 | (8.0) | 10.7 | (2.2) |

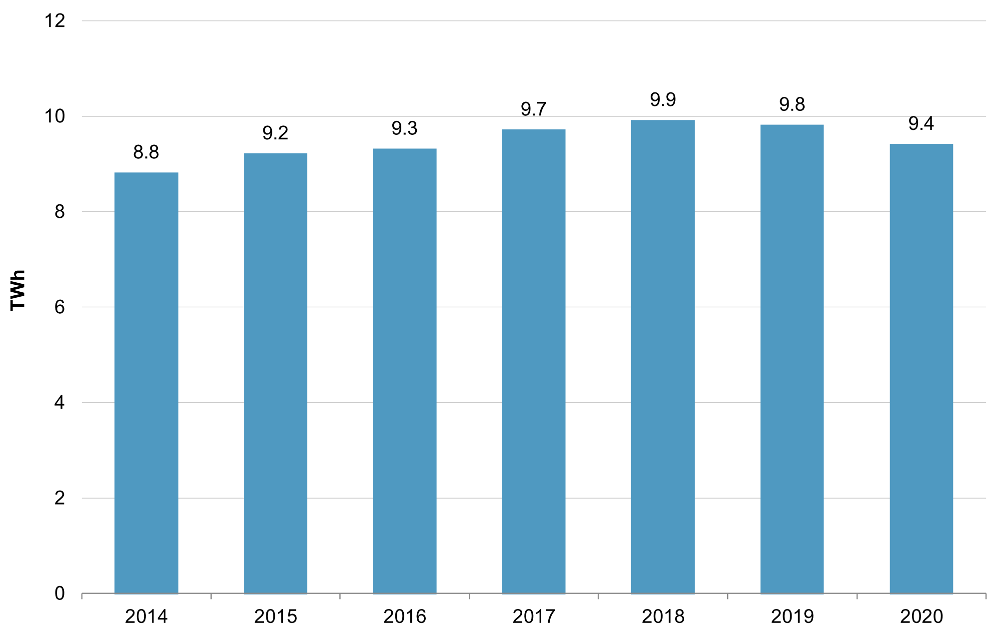
## Business Risk: Strong

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 2020, 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 revenue in ZSE's business mix as a supportive element, generating a reliable source of stable and predictable cash flow, while serving over 1 million customers. We believe the regulatory framework--supervised by the independent regulator, the RONI--is supportive and transparent, ensuring high predictability of earnings (see charts 2 and 3). We view ZSE's supply business as a negative credit factor because of its inherent exposure to merchant (price and demand) risk.

**Chart 2**

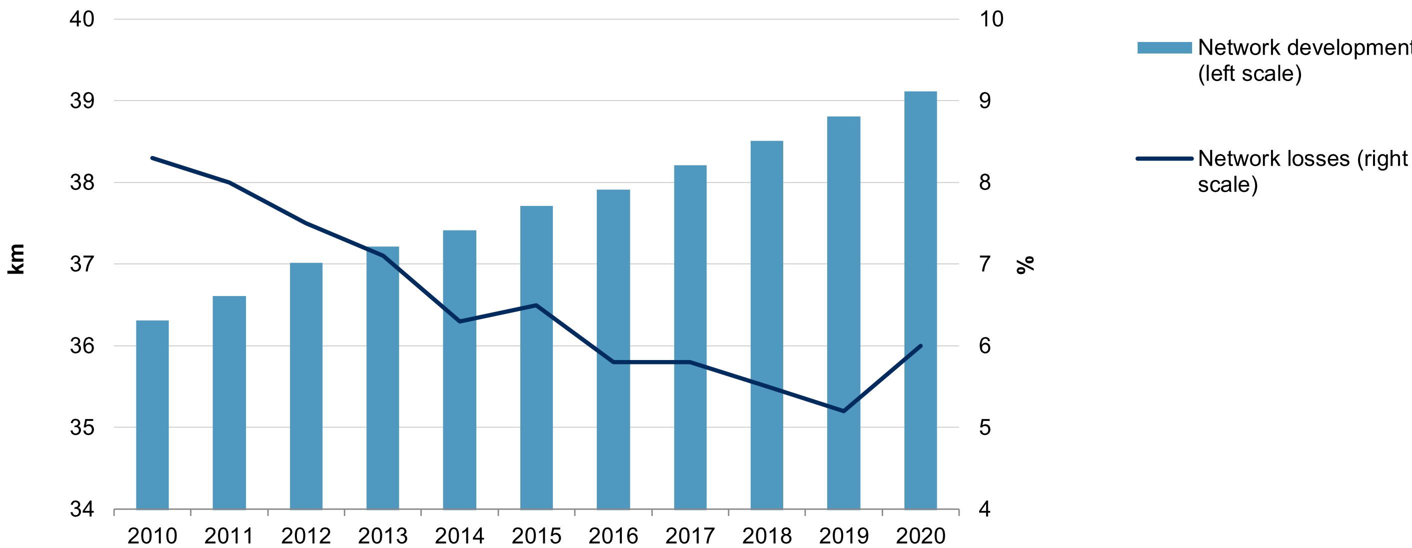
**Stable Distribution Volume**




TWh--Terawatt hours. Source: Company data.

**Chart 3**

**Reduced Network Losses And Stable Growth In New Connections**




km--Kilometers. Source: Company data.



## Financial Risk: Intermediate

Our base-case scenario for the utility assumes adjusted FFO to debt to remain above 25% over 2021 and 2022, 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-- | | | | |
|---|---|---|---|---|---|
| | 2020 | 2019 | 2018 | 2017 | 2016 |
| (Mil. €) | | | | | |
| Revenue | 1,210.8 | 1,284.8 | 1,124.5 | 1,065.0 | 1,001.3 |
| EBITDA | 256.9 | 245.9 | 206.8 | 202.8 | 197.7 |
| Funds from operations (FFO) | 209.7 | 210.4 | 145.5 | 144.8 | 155.3 |
| Interest expense | 19.2 | 19.2 | 26.2 | 23.4 | 26.0 |
| Cash interest paid | 18.6 | 18.9 | 22.5 | 22.3 | 22.4 |
| Cash flow from operations | 202.7 | 230.8 | 112.0 | 127.2 | 171.9 |
| Capital expenditure | 125.0 | 125.6 | 80.0 | 60.9 | 67.4 |
| Free operating cash flow (FOCF) | 77.7 | 105.2 | 32.1 | 66.3 | 104.5 |
| Discretionary cash flow (DCF) | 3.5 | 41.4 | (38.4) | 15.8 | 46.9 |
| Cash and short-term investments | 82.6 | 82.2 | 43.7 | 95.3 | 80.6 |
| Gross available cash | 82.6 | 82.2 | 43.7 | 95.3 | 80.6 |
| Debt | 586.9 | 586.9 | 608.8 | 552.5 | 568.6 |
| Equity | 217.4 | 155.5 | 79.6 | 50.2 | 3.1 |
| Adjusted ratios | | | | | |
| EBITDA margin (%) | 21.2 | 19.1 | 18.4 | 19.0 | 19.7 |
| Return on capital (%) | 25.1 | 26.4 | 24.1 | 25.9 | 25.6 |
| EBITDA interest coverage (x) | 13.4 | 12.8 | 7.9 | 8.7 | 7.6 |
| FFO cash interest coverage (x) | 12.3 | 12.1 | 7.5 | 7.5 | 7.9 |
| Debt/EBITDA (x) | 2.3 | 2.4 | 2.9 | 2.7 | 2.9 |
| FFO/debt (%) | 35.7 | 35.8 | 23.9 | 26.2 | 27.3 |
| Cash flow from operations/debt (%) | 34.5 | 39.3 | 18.4 | 23.0 | 30.2 |
| FOCF/debt (%) | 13.2 | 17.9 | 5.3 | 12.0 | 18.4 |
| DCF/debt (%) | 0.6 | 7.1 | (6.3) | 2.9 | 8.3 |

## Reconciliation

**Table 3**

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

| | --Fiscal year ended Dec. 31, 2020-- | | | | | | |
|---|---|---|---|---|---|---|---|
| Zapadoslovenska energetika a.s. reported amounts | | | | | | | |
| | Debt | EBITDA | Operating income | Interest expense | S&P Global Ratings' adjusted EBITDA | Cash flow from operations | Capital expenditure |
| Reported | 634.7 | 239.8 | 176.8 | 17.3 | 256.9 | 204.0 | 126.8 |
| S&P Global Ratings' adjustments | | | | | | | |
| Cash taxes paid | -- | -- | -- | -- | (28.6) | -- | -- |
| Cash interest paid | -- | -- | -- | -- | (16.7) | -- | -- |
| Reported lease liabilities | 24.5 | -- | -- | -- | -- | -- | -- |

**Table 3**

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

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Postemployment benefit obligations/deferred compensation | 10.3 | -- | -- | 0.1 | -- | -- | -- |
| Accessible cash and liquid investments | (82.6) | -- | -- | -- | -- | -- | -- |
| Capitalized interest | -- | -- | -- | 1.8 | (1.8) | (1.8) | (1.8) |
| Dividends received from equity investments | -- | 0.5 | -- | -- | -- | -- | -- |
| Income (expense) of unconsolidated companies | -- | (0.5) | -- | -- | -- | -- | -- |
| Nonoperating income (expense) | -- | -- | 0.0 | -- | -- | -- | -- |
| Reclassification of interest and dividend cash flows | -- | -- | -- | -- | -- | 0.5 | -- |
| EBITDA: Gain (loss) on disposals of PP&E | -- | 0.1 | 0.1 | -- | -- | -- | -- |
| EBITDA: Other | -- | 17.0 | 17.0 | -- | -- | -- | -- |
| Total adjustments | (47.8) | 17.1 | 17.1 | 1.9 | (47.2) | (1.3) | (1.8) |
| **S&P Global Ratings' adjusted amounts** | | | | | | | |
| | **Debt** | **EBITDA** | **EBIT** | **Interest expense** | **Funds from operations** | **Cash flow from operations** | **Capital expenditure** |
| Adjusted | 586.9 | 256.9 | 193.9 | 19.2 | 209.7 | 202.7 | 125.0 |

PP&E--Property, plant, and equipment.

## 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 1.5x 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, 2021.

### Principal Liquidity Sources

We anticipate the company will have the following principal liquidity sources over the 12 months started March 31, 2021:

- Access to unrestricted short-term cash of about €96 million.
- Undrawn committed credit facilities of €75 million maturing in October 2023.
- Our forecast that ZSE will generate about €200 million of cash FFO annually.

### Principal Liquidity Uses

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 maturity is in October 2023).
- About €310 million of total capital investments over the coming two years.
- Dividend payments of approximately €90 million in 2021.

## Covenant Analysis

We understand that the euro medium-term note program does not contain any covenants. However, ZSE's liquidity credit facilities are subject to early repayment if we lower the rating to speculative grade ('BB+' and below). 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 the company'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. Given ZSE's solid SACP at 'a-', at this level, support from the government of Slovakia does not result in any additional uplift.

## 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
- 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: Industry Risk, 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
- Principles Of Credit Ratings, Feb. 16, 2011

## Related Research

- Favorable 2020 Results Indicate E.ON SE Is On Track For Accelerated Deleveraging, March 24, 2021
- The Energy Transition And The Diverging Credit Path For European Utilities, Feb. 16, 2021
- Slovakia's Electricity And Gas Regulatory Framework: Supportive, Oct. 6, 2020
- E.ON SE, July 15, 2020

**Business And Financial Risk Matrix**

| | Financial Risk Profile | | | | | |
|---|---|---|---|---|---|---|
| **Business 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 August 11, 2021)***

| | |
|---|---|
| **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.