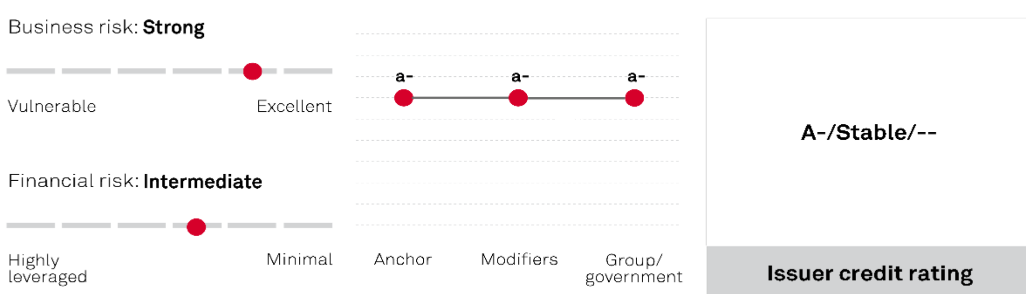
Zapadoslovenska energetika a.s.

October 20, 2023

Ratings Score Snapshot



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Credit Highlights

Overview

Key strengths	Key risks
Stable and predictable low-risk regulated businesses account for 90% of the group's 2022 EBITDA.	Exposure to competition and merchant risk through unregulated retail activities, though these account for less than 10% of group EBITDA.
Monopoly market position as the only electricity distribution system operator in Western Slovakia, and the largest of the country's three distribution system operators (DSOs), accounting for 50% of the total distributed volume.	Aggressive dividend policy with a payout ratio of about 100%.
After the upcoming consolidation with Vychodoslovenska Energetika Holding a.s. (VSE), the joint entity will represent 70% of the total distributed power volume in Slovakia.	The Slovak Regulatory Office for Network Industries (RONI) determines distribution tariffs and regulated electricity and gas supply prices, leading to regulatory risk.

We expect the consolidation of ZSE and VSE to close by first-quarter 2024. Zapadoslovenska energetika a.s. (ZSE) and Vychodoslovenska Energetika Holding a.s. (VSE; not rated) have the same shareholders; E.ON SE (BBB/Stable/A-2) has a 49-percent stake and the Slovak Republic

(A+/Stable/A-1) has a 51-percent stake. VSE has similar operations as ZSE, as a natural monopoly in power distribution, but in Eastern Slovakia. On April 8, 2022, E.ON SE and the Slovak Republic agreed to consolidate ZSE and VSE. However, the two entities can only be consolidated on meeting the conditions precedent set out in the agreement. The last of the conditions precedent, which was approval of the government, was fulfilled in June 2023 and the transaction is expected to close by first quarter of 2024. After this, ZSE will become VSE's sole shareholder with no changes to ZSE's ownership structure. We will continue to monitor the transaction to ascertain how it might affect ZSE's business and financial risk, but overall, we expect the transaction to be marginally beneficial due to the increased economies of scale. We do not expect the enlarged group's debt leverage or credit ratios to materially change, given that VSE has lower leverage than ZSE. Combined, ZSE and VSE will account for 70% of the total distributed power volume in Slovakia.

High energy prices in Europe and grid loss costs depressed 2022 results. EBITDA growth for 2022 was constrained by the acute increase in energy prices triggered by the Russia-Ukraine conflict and affected ZSE's DSO segment due to high spot prices and increasing grid loss costs. S&P Global Ratings-adjusted EBITDA for 2022 stood at €243 million, down from €265 million in 2021. As a result, adjusted funds frm operations (FFO) to debt declined to 25.6% (versus 30.3% in 2021) and adjusted debt to EBITDA at 3.1x (versus 2.5x in 2021). However, this is well above our downside threshold of 18% for the rating. We expect an increase in earnings from supply and production will allow adjusted FFO to debt to rebound to 30% in 2023. ZSE also benefits from stable and predictable earnings secured by regulated cash flows, as more than 90% of the company's EBITDA is regulated.

Cash flow stability is expected to continue in the new regulatory period (2023-2027) driven by a predictable and supportive framework. Slovakia's regulatory framework for electricity and gas networks is supervised by an independent regulator, RONI. The new five-year regulatory period for both gas and electricity distribution networks started in 2023 and is valid until 2027 and the group's earnings are inherent to RONI's pricing decisions for distribution tariffs and regulated electricity and gas supply prices. Largely as we expected, the final version of RONI secondary legislation attests to lowering the pre-tax weighted-average cost of capital (WACC) to 4.99% (versus 5.09% in 2022), which we have incorporated into our base-case scenario. There is an additional 2% premium to the WACC for renewable energy storage and battery connections, digitalization, smart grid etc., with an annual cap for a plus or minus10% change if input parameters change by over and including 20%. Grid loss costs, which depressed the group's EBITDA in 2022, will now be based on a forward price settlement with a correction mechanism (based on actual costs and revenues) from 2024. This change will ensure that there is no risk of deficit and time delay of the cost reflections in tariffs. S&P Global Ratings continues to view the regulatory framework as stable and transparent, ensuring highly predictable earnings over the 2023-2027 regulatory period.

The Slovak state has the call option to acquire Malzenice Power Plant by the end of 2024 and we have excluded Malzenice from our base-case scenario and forecasts. Malzenice was purchased from E.ON in Q3 2018, a Combined Cycle Gas Turbine (CCGT) power plant with installed capacity of 436 megawatts (MW). Since 2022, we have excluded Malzenice-related investments mostly driven by higher CO_2 purchase costs, as we treat it as non-core asset. The state considers Malzenice's operations will support the security and stability of the electricity grid network.

Outlook

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 and will remain shielded against the current energy crisis.

Downside scenario

We could lower the rating on ZSE if we took a similar rating action on Slovakia and--at the same time--revised downward the utility's stand-alone credit profile (SACP) by 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 downward 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 network losses settlement on spot payments 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 downward the SACP if the utility's credit metrics weakened, notably if adjusted FFO to debt fell below 18% without any prospect of recovery. This could occur if the company adopted more aggressive shareholder policies in terms of leverage tolerance or dividend payouts.

Upside scenario

We are unlikely to upgrade ZSE due to its stable cash flow profile combined with its aggressive financial policy. We could raise the rating on ZSE if we upgraded Slovakia, or if ZSE posted 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

- Pretax weighted-average cost of capital (WACC) set at 4.99% plus a 2% premium with an annual cap for plus or minus 10% change if input parameters change by over and including 20%.
- An investment plan, supported by organic growth (mainly network enhancement projects and renewable connections), to be about €120 million-€130 million, on average, for 2022-2026. We exclude Malzenice related investments from 2022.

- Dividend payout ratio of about 80%-100%, but flexible according to rating and liquidity considerations.
- Slovakia real GDP growth assumed to be 1.5% for 2022, 0.4% for 2023, and 2.0% for 2024.
- Anticipated merger between ZSE and VSE to close in first-quarter 2024.

Key metrics

Zapadoslovenska energetika a.s.--Forecast summary (excl. VSE)

Period ending	Dec-31-2019	Dec-31-2020	Dec-31-2021	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025
(Mil. EUR)	2019a	2020a	2021a	2022a	2023f	2024f	2025f
EBITDA	246	257	265	243	231	266	220
Funds from operations (FFO)	210	210	204	191	190	223	183
Capital expenditure (capex)	126	125	136	108	146	137	135
Dividends	64	74	90	88	73	101	92
Debt	587	587	672	747	635	649	692
Adjusted ratios							
Debt/EBITDA (x)	2.4	2.3	2.5	3.1	2.7	2.4	3.1
FFO/debt (%)	35.8	35.7	30.3	25.6	29.9	34.3	26.5
FOCF/debt (%)	17.9	13.2	0.2	(3.9)	28.4	13.4	7.1

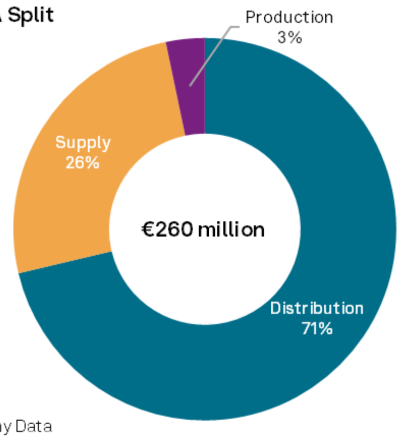
Company Description

ZSE is the sole DSO in the relatively wealthy service area of Western Slovakia and has a very strong position as the region's electricity supplier. It is the largest of three regional DSO providers in the country (ZSE, Stredoslovenska energetika [SSE], and 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 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 2022, ZSE distributed 9.6 terawatt-hours (TWh) of electricity throughout Western Slovakia (compared with 9.9 TWh in 2021) and supplied 6.5 TWh of the power and 2.8 TWh of gas.

At year-end 2022, ZSE posted EBITDA of €260 million (S&P Global Ratings-adjusted: €243 million) and financial debt of €765 million (S&P Global Ratings-adjusted: €747 million), which leads to our adjusted FFO-to-debt ratio of about 25.6%.

Chart 1



Source. Company Data

Peer Comparison

Zapadoslovenska energetika a.s.--Peer Comparisons

	Zapadoslovenska energetika a.s.	Electricity Supply Board	Alliander N.V.	CEZ a.s.	Electricity North West Ltd.
Foreign currency issuer credit rating	A-/Stable/--	A-/Stable/A-2	A+/Watch Pos/A-1	A-/Stable/--	BBB+/Negative/A-2
Local currency issuer credit rating	A-/Stable/--	A-/Stable/A-2	A+/Watch Pos/A-1	A-/Stable/--	BBB+/Negative/A-2
Period	Annual	Annual	Annual	Annual	Annual
Period ending	2022-12-31	2022-12-31	2022-12-31	2022-12-31	2022-03-31
Mil.	EUR	EUR	EUR	EUR	EUR
Revenue	1,991	7,507	2,150	11,634	561
EBITDA	243	1,686	773	5,601	338
Funds from operations (FFO)	191	1,312	653	5,191	182
Interest	19	178	49	269	86
Cash interest paid	19	176	60	186	93
Operating cash flow (OCF)	79	528	562	197	213
Capital expenditure	108	1,142	1,229	1,391	246
Free operating cash flow (FOCF)	(29)	(614)	(667)	(1,194)	(33)
Discretionary cash flow (DCF)	(117)	(753)	(766)	(2,256)	(101)
Cash and short-term investments	48	431	204	1,919	93
Gross available cash	48	431	204	1,923	93

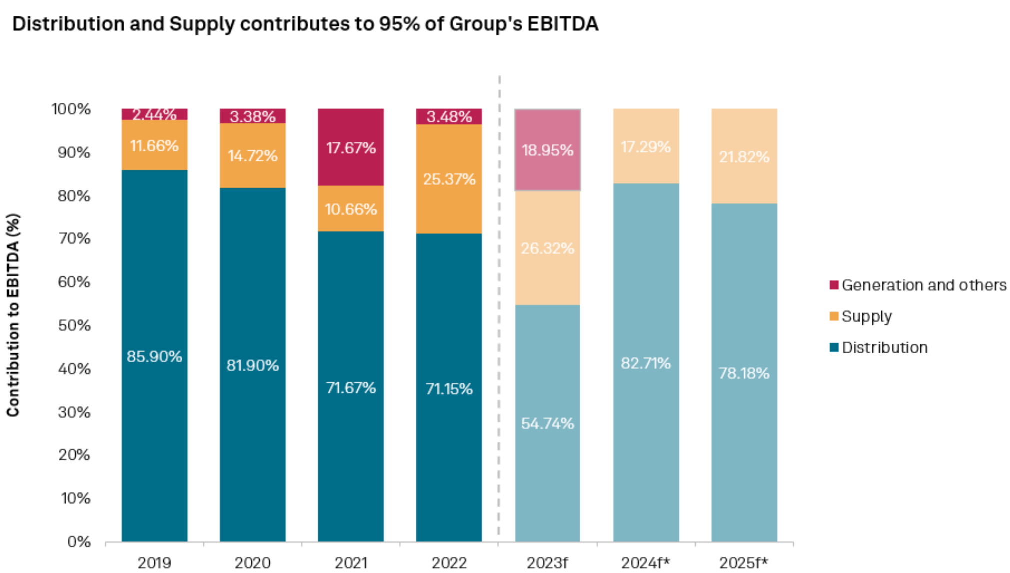
Zapadoslovenska energetika a.s.--Peer Comparisons

Debt	747	7,264	3,314	10,645	2,155
Equity	313	4,782	4,622	10,774	706
EBITDA margin (%)	12.2	22.5	36.0	48.1	60.2
Return on capital (%)	17.5	7.7	4.2	23.9	6.2
EBITDA interest coverage (x)	12.7	9.5	15.9	20.8	3.9
FFO cash interest coverage (x)	11.3	8.5	11.8	28.9	2.9
Debt/EBITDA (x)	3.1	4.3	4.3	1.9	6.4
FFO/debt (%)	25.6	18.1	19.7	48.8	8.4
OCF/debt (%)	10.6	7.3	17.0	1.8	9.9
FOCF/debt (%)	(3.9)	(8.5)	(20.1)	(11.2)	(1.5)
DCF/debt (%)	(15.7)	(10.4)	(23.1)	(21.2)	(4.7)

Business Risk

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 2022, 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 ZSE's supply business as a negative credit factor because of its inherent exposure to merchant (price and demand) risk.

Chart 2



*EBITDA from Malzenice excluded due to the pre-emption right of the Slovakian State. Source: S&P Global Ratings

Positive regulatory developments enhance the stability and predictability of ZSE's remuneration and confirms the supportiveness of the Slovak regulatory framework. 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. For this regulatory period (2023-2027), RONI introduced changes to the allowed revenues formula that has had a positive impact on the total allowed revenue. Significant changes include:

-- RAB calculation will be IFRS accounting value of t-2 (31.12.2021) instead of the fixed 2010 level.

-- For electricity, regulatory depreciation is adjusted for actual investment in period t-2 as well as planned investments in t-1. For instance, 2024 regulatory depreciation will correspond to accounting depreciation of 2022.

-- RONI implemented a WACC premium of 2% with annual cap for +-10% change if input parameters changes >20%. In accordance, RONI published WACC for 2024+ at 5.18% due to change in input parameters >20% (Market risk premium).

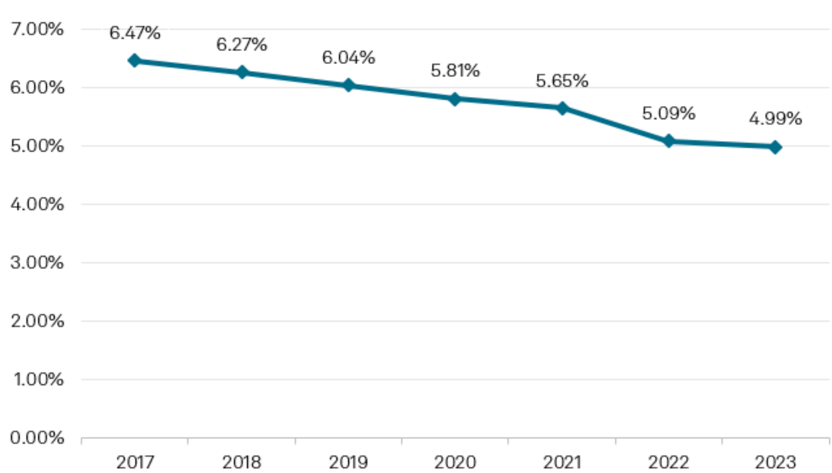
-- Eligible operating expenditure is based on historical 2021 financials for personnel costs (perex) and three-year average (2019-2021) for other opex. Personnel costs are subject to escalation by the index of nominal wages in Slovakia, while other operating costs are escalated by a core inflation index with an efficiency factor of 2%.

-- The new electricity framework also includes a compensation mechanism for network losses starting from Jan. 1, 2024.

We view the Slovak framework as somewhat weaker than that of other Eastern European Countries, such as the Czech Republic but we will continue to monitor the framework and the implementation of the changes into the new regulatory period to further assess its credit supportiveness.

Chart 3

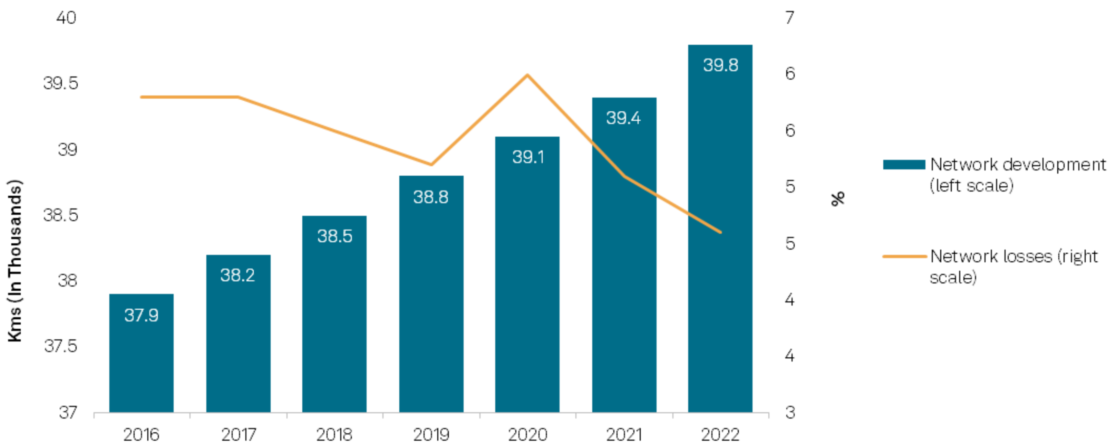
Regulatory WACC Development



WACC--Weighted average cost of capital. Source: Company data.

Chart 4

Continous Reduction in Network Losses And Stable Growth In Network Development



Kms--Kilometers. Source: Company data.

Financial Risk

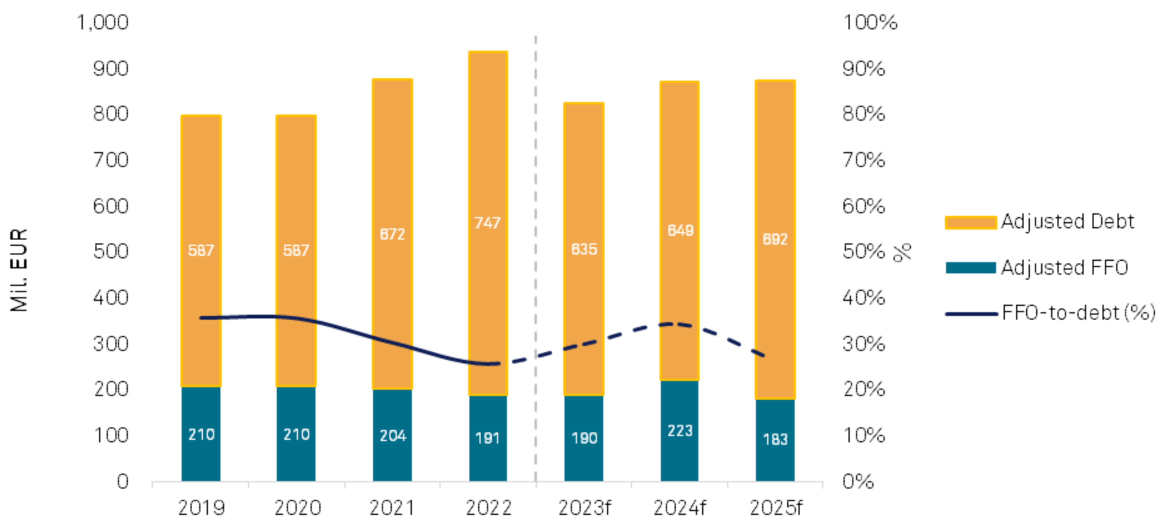
We see ZSE's significant headroom under and commitment to the rating as supportive for the rating. Our base-case scenario for the utility assumes adjusted FFO to debt to remain above 25% over 2023 and 2024, leaving ample headroom to our downside threshold of 18% for the rating.

We expect ZSE's capital expenditure spendings to be around €140 million-€150 million for 2023 and €130 million-€140 million for 2024. We view the company's limited investment requirements positively, as it results in positive free operating cash flow of €180 million in 2023 and €80 million-€90 million in 2024. 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. We forecast ZSE will pay €73 million of dividends in 2023, resulting in a positive discretionary cash flow of €100 million-€110 million for 2023.

ZSE is exposed to some degree of refinancing risk through its uneven maturity profile. Some 50% of debt matures every five years. That said, ZSE refinanced its €315 million bond due in Oct 2023 through three long-term (LT) bank loans due in October 2028. There is another outstanding bond of €315 million due in March 2028. With successful refinancing of the bond (€315 million, due Oct 2023) around 100% of the total debt now matures in less than 5 years.

Chart 5

FFO to debt Evolution



Mil.--Million. F--forecast Source: S&P Global Ratings.

Zapadoslovenska energetika a.s.--Financial Summary

Period ending	Dec-31-2017	Dec-31-2018	Dec-31-2019	Dec-31-2020	Dec-31-2021	Dec-31-2022
Reporting period	2017a	2018a	2019a	2020a	2021a	2022a
Display currency (mil.)	EUR	EUR	EUR	EUR	EUR	EUR
Revenues	1,065	1,125	1,285	1,211	1,341	1,991
EBITDA	203	207	246	257	265	243
Funds from operations (FFO)	145	145	210	210	204	191
Interest expense	23	26	19	19	19	19
Cash interest paid	22	22	19	19	19	19
Operating cash flow (OCF)	127	112	231	203	138	79
Capital expenditure	61	80	126	125	136	108
Free operating cash flow (FOCF)	66	32	105	78	2	(29)
Discretionary cash flow (DCF)	16	(38)	41	4	(88)	(117)
Cash and short-term investments	95	44	82	83	11	48
Gross available cash	95	44	82	83	11	48
Debt	553	609	587	587	672	747
Common equity	50	80	155	217	269	313
Adjusted ratios						
EBITDA margin (%)	19.0	18.4	19.1	21.2	19.7	12.2
Return on capital (%)	25.9	24.1	26.4	25.1	23.1	17.5
EBITDA interest coverage (x)	8.7	7.9	12.8	13.4	13.8	12.7

Zapadoslovenska energetika a.s.--Financial Summary

FFO cash interest coverage (x)	7.5	7.5	12.1	12.3	12.0	11.3
Debt/EBITDA (x)	2.7	2.9	2.4	2.3	2.5	3.1
FFO/debt (%)	26.2	23.9	35.8	35.7	30.3	25.6
OCF/debt (%)	23.0	18.4	39.3	34.5	20.5	10.6
FOCF/debt (%)	12.0	5.3	17.9	13.2	0.2	(3.9)
DCF/debt (%)	2.9	(6.3)	7.1	0.6	(13.1)	(15.7)

Reconciliation Of Zapadoslovenska energetika a.s. Reported Amounts With S&P Global Adjusted Amounts (Mil. EUR)

	Debt	Shareholder Equity	Revenue	EBITDA	Operating income	Interest expense	S&PGR adjusted EBITDA	Operating cash flow	Dividends	Capital expenditure
Financial year	Dec-31-2022									
Company reported amounts	765	311	1,991	260	192	17	243	80	88	110
Cash taxes paid	-	-	-	-	-	-	(33)	-	-	-
Cash interest paid	-	-	-	-	-	-	(17)	-	-	-
Lease liabilities	24	-	-	-	-	-	-	-	-	-
Postretirement benefit obligations/ deferred compensation	6	-	-	0	0	0	-	-	-	-
Accessible cash and liquid investments	(48)	-	-	-	-	-	-	-	-	-
Capitalized interest	-	-	-	-	-	2	(2)	(2)	-	(2)
Noncontrolling/ minority interest	-	2	-	-	-	-	-	-	-	-
EBITDA: other	-	-	-	(17)	(17)	-	-	-	-	-
Total adjustments	(18)	2	-	(16)	(16)	2	(52)	(1)	-	(2)
S&P Global Ratings adjusted	**Debt**	**Equity**	**Revenue**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from Operations**	**Operating cash flow**	**Dividends**	**Capital expenditure**
	747	313	1,991	243	176	19	191	79	88	108

Liquidity

We assess the company's liquidity as adequate. This is despite our estimate that its liquidity sources, including cash, FFO, committed credit facilities, and working capital inflows will cover expected cash outflows by more than 2.6x in the 12 months started June 30, 2023. ZSE has a relatively lumpy maturity profile and does not refinance any debt more than a year before its maturity, which could temporarily lower uses over sources. ZSE has sound relationships with banks, and the recent refinancing of €315 million bond maturing in October 2023 through bank loans demonstrated 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.

Principal liquidity sources

We anticipate the company will have the following principal liquidity sources as of June 30, 2023:

Access to unrestricted short-term cash of about €210 million;

Undrawn committed credit facilities of about €100 million;

Cash FFO of €190 million-€200 million; and

Working capital inflows of about €20 million.

Principal liquidity uses

We anticipate the company will have the following principal liquidity uses as of June 30, 2023:

Capital expenditure of around €120 million-€130 million; and

Dividend payments of about €80 million.

Covenant Analysis

Compliance expectations

We understand that the euro medium-term note program does not contain any covenants. However, one of ZSE's loan facilities of €158 million is subject to early repayment if we lower the rating to speculative grade ('BB+' and below). ZSE's liquidity facilities of €100 million do not contain any covenants.

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 comprises senior unsecured debt at the parent level.

Analytical conclusions

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

Rating Component Scores

Foreign currency issuer credit rating	A-/Stable/--
Local currency 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-
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	a-

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Eastern European Utilities' Regulatory Frameworks Are Varied, But Most Are Adequate To Strong, Sept. 18, 2023
- Eastern Europe: Credit Resilience Despite Increasing Affordability Concerns, Jan. 13, 2023
- Eastern European Utilities Handbook 2023, Jan. 5, 2023

Ratings Detail (as of October 20, 2023)*

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.