Research Update:

Zapadoslovenska energetika Upgraded To 'A' On Successful Consolidation Of Vychodoslovenska energetika; Outlook Stable

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Rating Action Overview

- Zapadoslovenska energetika (ZSE) completed the consolidation of Vychodoslovenska energetika (VSE) in November 2023 and is progressing well with the integration.
- The combined entity will distribute a high 70% share of the total distributed power volume in Slovakia, becoming by far the largest power distributor in the country.
- The consolidation will also boost ZSE's scale, with the S&P Global Ratings-adjusted EBITDA of the combined entity at about €375 million in 2024, and is expected to lead to some economy of scale benefits.
- We expect the integration will improve the group's financial position and we forecast funds from operations (FFO) to debt, without volume or price impact, of around 28%-30% in 2025-2026, which is well above our 23% threshold for the rating.
- ZSE's newly revised financial policy stipulating maximum leverage of 3.1x in 2024 and 3.0x in 2025 strongly supports our expectations.
- We therefore raised our long-term issuer credit and issue ratings on ZSE and its senior unsecured debt to 'A' from 'A-'.
- 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 and FFO to debt remaining sustainably above 23%, and likely closer to 25%.

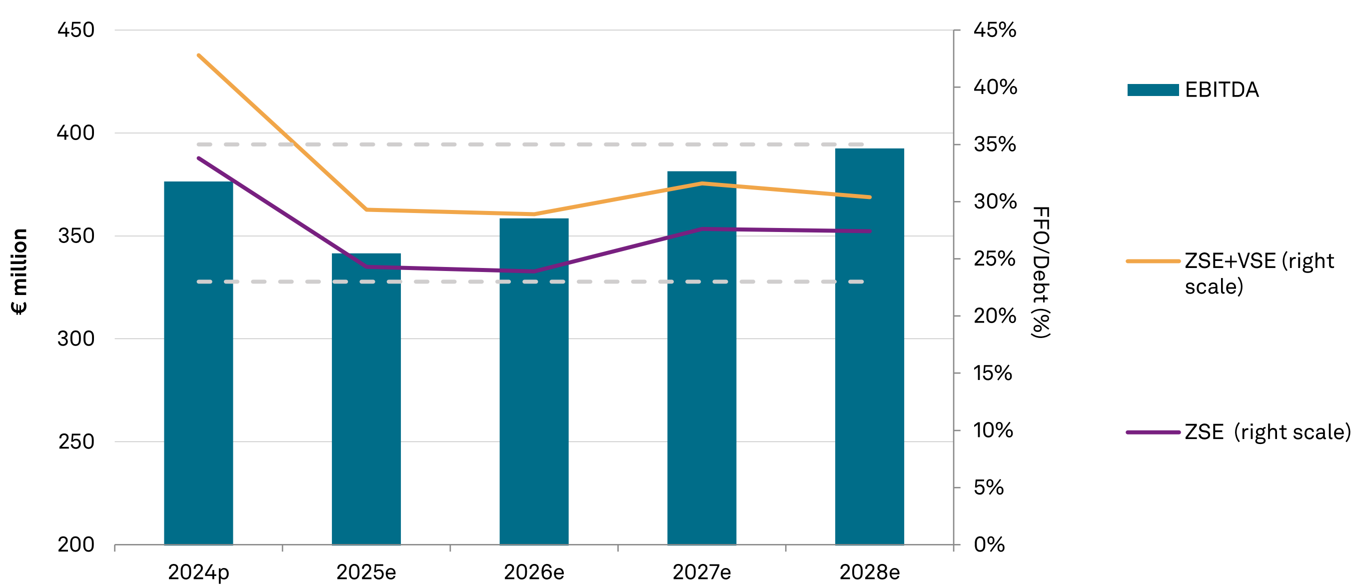
Rating Action Rationale

The integration of VSE will strengthen ZSE's credit metrics, given VSE's lower leverage and expected synergies. The upgrade follows our view on ZSE's robust cash flows, which supports our 'A' rating, with our forecast FFO to debt remaining well above 23% until Dec. 31, 2027, the end of the current regulatory period for power grids in Slovakia. Following the successful consolidation of VSE (Slovakia's natural power distribution monopoly in eastern Slovakia) in November 2023, we forecast S&P Global Ratings-adjusted EBITDA in 2024 around €370 million–€380 million, thanks to VSE's full-year contribution, down from a record high €417.4 million in 2023, and then to remain €340 million-€360 million over 2025-2026. Our forecast EBITDA also assumes synergies achieved by the integration. We will monitor the progress with the integration, but economies of scale, effectiveness, and elimination of duplicates will support ZSE's credit metrics, in our view. The positive financial impact is also attributable the fact that VSE's leverage was lower at the time of the consolidation and stood at 1.2x at year-end 2023 compared with ZSE's at 1.4x for the same period.

At the same time, we expect ZSE's capital expenditure to be around €210 million-€215 million annually for the next two to three years. We view the group's limited investment requirements positively, as it results in positive FOCF of €50 million-€70 million annually.

Chart 1

Evolution of EBITDA and FFO/Debt



Footnote: p--projections, e--estimates. Source: S&P Global Ratings

The upgrade further reflects supportive financial policy, which is now embedded in the new shareholder agreement. The new shareholder agreement includes a clear indication for dividend and maximum leverage, which we deem as credit supportive because it provides increased visibility of expected leverage. The maximum leverage ratio (defined by ZSE as interest- bearing debt minus cash on hand divided by three years' EBITDA average) is set as following:

- 2024: maximum 3.1x
- 2025 and thereafter: maximum 3.0x

We forecast S&P Global Ratings-adjusted debt to EBITDA for 2024 at 1.7x, which is well below the maximum leverage, but then to increase to around 2.6x-2.7x in 2025-2026. We note that the company's financial policy follows a 100% dividend payout ratio, but it is flexible if necessary to maintain maximum leverage and liquidity position and hence we assess ZSE's stand-alone credit profile (SACP) at 'a'. We forecast ZSE will pay around €100 million-€110 million of dividends in 2024, resulting in a negative discretionary cash flow of around €50 million-€60 million for 2024. Given the track record in terms of dividend payments, we view ZSE's shareholders, Slovakia (51%) and E.ON (49%), as supportive but expect that dividends likely will increase to push leverage to the maximum leverage ratio according to the financial policy.

The combined group's business risk positioning is marginally stronger, given the increased scale, but the predictable and supportive regulatory framework remains the key strength. The ZSE group now owns and operates the entire power distribution network in both western (ZSE) and eastern (VSE) Slovakia. Though eastern Slovakia is less economically developed than its western counterpart, it offers excellent diversification and the combined entity will now account for a high 70% of the total distributed power volume in Slovakia. The ZSE group has also become the market leader in power supply with a 43% market share, and the second-largest gas supplier with a 17% market share. Given the increased scale of operations, combined with a large and stable customer base with lower churn rates, our view of the ZSE group's business risk has strengthened marginally within the strong business risk profile. The predictable and supportive framework ensures cash flow stability and underpins the group's business risk, in our view. 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. We forecast that the group will derive 85%-90% of its EBITDA from regulated activities (predominantly electricity distribution, along with electricity and gas supply to households and small and midsize enterprises). Slovakia's regulatory framework for electricity and gas networks is supervised by an independent regulator, Regulatory Office for Network Industries (RONI). The new five-year regulatory period for both gas and electricity distribution networks started Jan. 1, 2023 and is valid until Dec. 31, 2027, and the group's earnings are inherent to RONI's pricing decisions for distribution tariffs and regulated electricity and gas supply prices.

ZSE posted strong 2023 results, notably due to one-offs. ZSE significantly outperformed our forecasts in 2023, due to one-off effects in the form of recoveries of the network losses deficit from the previous regulatory period. These one-offs are not sustainable. In total ZSE received €76 million stemming from the temporary effect on earnings from volume and price effects that average out over the years. Recovery in 2023 was unusually high owing to the high power price and volatility in 2022 and part of 2023. With the successful completion of the consolidation of VSE, EBITDA was added on a pro rata basis, and balance sheet on a full basis, and the contribution of EBITDA was approximately €15 million, and as a result, S&P Global Ratings-adjusted EBITDA for 2023 stood at €417.3 million, up from €243.1 million in 2022. Adjusted FFO to debt in 2023 stood at 59.7%, significantly higher than 25.6% in 2022, and adjusted debt to EBITDA stood at 1.4x (versus 3.1x in 2022). For 2025-2026 we expect adjusted FFO to debt to normalize (i.e., excluding the temporary earnings boost from the volume and price effects) around 28-30%, which we deem well in line with the rating. ZSE also benefits from stable and predictable earnings secured by regulated cash flows, as more than 86% of the company's EBITDA is regulated.

Slovakia exercised the call option to acquire Malzenice Power Plant which should be completed in second half of 2024. Malzenice was purchased from E.ON in the third-quarter of 2018, a combined cycle gas turbine power plant with installed capacity of 436 megawatts. Since 2022, we have excluded Malzenice-related investments, mostly driven by higher carbon dioxide purchase costs as well as positive operating cash-flow contribution, because we treat the power plant as a noncore 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 in western and eastern Slovakia. We also anticipate that the utility will maintain its very strong retail supply position in its service area. Over the next two years we expect FFO to debt at about 28%-30%, which we see commensurate with the current 'a' SACP.

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 our assessment of the utility's 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 one notch without revising down our view of extraordinary state support. This could occur if there were unexpected negative changes to the regulatory framework, or if 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 to 23% without any prospect of recovery. This could occur if the company adopted more aggressive shareholder policies in terms of leverage tolerance or dividend payouts, which we view unlikely due to the recent change in the shareholder agreement.

Upside scenario

We see an upgrade as remote. We could raise the rating on ZSE if we upgraded Slovakia, or if ZSE posted an adjusted FFO-to-debt ratio sustainably above 35%, assuming our view of the likelihood of extraordinary government support did not change.

Company Description

ZSE and VSE have the same shareholders: E.ON (BBB+/Stable/A-2) has a 49% stake and Slovakia (A+/Stable/A-1) has a 51% stake. ZSE is the sole distribution system operator in the relatively wealthy service area of western Slovakia and has a very strong position as the region's electricity supplier. On the other hand, VSE has similar operations as ZSE, as a natural monopoly in power distribution, but in eastern Slovakia.

On April 8, 2022, E.ON and Slovakia agreed to consolidate ZSE and VSE and the consolidation was completed at the end of 2023. Combined, ZSE and VSE now account for 70% of the total distributed power volume in Slovakia and the combined entity is a market leader in power supply, with a 43% market share, and the second-largest gas supplier, with a 17% market share. Although ZSE is 51% state controlled, the company's operations and strategy are sufficiently autonomous.

In 2023, ZSE distributed 9.8 terawatt-hours (TWh) of electricity (compared with 9.6 TWh in 2022) and supplied 6.7 TWh of the power and 2.7 TWh of gas. At year-end 2023, ZSE posted EBITDA of

€423.7 million (S&P Global Ratings-adjusted: €417.3 million) and financial debt of €830 million (S&P Global Ratings-adjusted: €585.5 million), which leads to our adjusted FFO-to-debt ratio of about 59.7%.

Our Base-Case Scenario

Assumptions

- Slovakia real GDP to grow at 2.0% in 2024, 2.9% for 2025, and 1.9% for 2026.
- Regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2027).
- Pre-tax weighted average cost of capital set at 5.18% for 2024 (4.99% for 2023).
- Investment plan supported by EU funding to be about €200 million-€210 million on average between 2024-2028.
- Dividend payout of about 100%, although this is flexible according to rating and liquidity considerations. Maximum leverage ratio to be about 3.1x for 2024, and 3.0x from 2025 onwards.
- We exclude Malzenice from our base-case because it has been divested at fair value to the state.

Key metrics

Zapadoslovenska energetika a.s.--Key metrics*

	--Fiscal year ended Dec. 31--				
Mil. €	**2022a**	**2023a**	**2024e**	**2025f**	**2026f**
EBITDA	243.1	417.3	370-380	340-350	350-360
FFO	191.4	349.6	270-280	260-270	280-290
Capital expenditure	108.3	174.7	210-220	210-220	210-220
Debt	747.5	585.5	640-650	900-910	980-990
Funds from operations (FFO)/debt (%)	26	60	41-43	29-31	28-30

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. FFO--Funds form operations.

Liquidity

We assess ZSE's liquidity as adequate. Our view of ZSE's liquidity reflects our expectation that its liquidity sources will exceed its liquidity needs by 1.8x over the 12 months started March 31, 2024. ZSE has a relatively lumpy maturity profile and does not refinance any debt more than a year before its maturity, which could temporarily lower the uses-to-sources ratio. Nevertheless, ZSE has sound relationships with banks, and the recent refinancing of a €315 million bond maturing in October 2023 through bank loans 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.

We anticipate the company will have the following principal liquidity sources as of March 31, 2024:

- Access to unrestricted short-term cash of about €240 million;
- Undrawn committed credit facilities of about €157 million; and
- Cash FFO of about €270 million.

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

- No debt maturities over the next 12 months;
- Working capital outflows of about €8 million;
- Capital expenditure of around €210 million-€220 million; and
- Dividend payments of €157.5 million.

Covenants

We understand that the euro medium-term note program is not subject to any covenants. However, one of ZSE's loan facilities of €158 million is subject to early repayment if the rating is lowered to 'BB+' or below. That said, we do not anticipate any downside to the current investment-grade rating. This is because in the normal course of its business, ZSE's cash flows more than adequately cover its investment needs. ZSE's liquidity facilities of €100 million are not subject to any covenants.

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 risk
Industry risk	Very low risk
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Significant
Anchor	a-

Issuer Credit Rating	A/Stable/--
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	a
Related government rating	A+/Stable/A-1
Likelihood of government support	Moderately High

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Zapadoslovenska energetika a.s., Oct. 20, 2023

Ratings List

Upgraded

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

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.