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## Research Update:

# Slovakia-Based Electricity Network Operator Zapadoslovenska energetika (ZSE) Assigned 'BBB+' Rating; Outlook Stable

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## Research Update:

# Slovakia-Based Electricity Network Operator Zapadoslovenska energetika (ZSE) Assigned 'BBB+' Rating; Outlook Stable

## Overview

- We understand that Slovakia-based and majority state-owned electricity distribution and supply company Zapadoslovenska energetika (ZSE) is considering accessing the capital markets.
- We assess ZSE's stand-alone credit profile at 'bbb+', and believe there is a "moderately high" likelihood that the Republic of Slovakia would provide timely and sufficient extraordinary support to ZSE in the event of financial distress.
- We are therefore assigning our 'BBB+' long-term corporate credit rating to ZSE, and our 'BBB+' issue rating to ZSE's €1 billion euro medium-term note program.
- The stable outlook reflects our forecast of stable and predictable earnings from ZSE's relatively low-risk regulated distribution business, as well as financial metrics commensurate with our assessment of its "significant" financial risk profile.

## Rating Action

On Sept. 25, Standard & Poor's Ratings Services assigned its 'BBB+' long-term corporate credit rating to Slovakia-based, 51% state-owned, electricity distribution and supply company Zapadoslovenska energetika (ZSE). The outlook is stable.

At the same time, we assigned our 'BBB+' issue rating to ZSE's €1 billion euro medium-term note program.

## Rationale

The rating reflects our assessment of ZSE's stand-alone credit profile (SACP) as 'bbb+'. The SACP reflects our view that ZSE has a "strong" business risk profile and "significant" financial risk profile, as our criteria define those terms.

We also believe that there is a "moderately high" likelihood that the Republic of Slovakia would provide timely and sufficient extraordinary support to ZSE in the event of financial distress. In accordance with our criteria for government-related entities (GREs), our view of a "moderately high" likelihood of extraordinary support reflects 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.
- "Strong" link with the Slovak government, which owns, through the National Property Fund, 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. We view ZSE's direct owner, the National Property Fund, as a government conduit.

Our assessment of ZSE's business risk profile as "strong" reflects the company's monopoly market position as an electricity distribution operator in the relatively wealthy service area of Western Slovakia. We believe that the regulatory framework--supervised by the independent regulator RONI (Slovak Regulatory Office for Network Industries)--is supportive and transparent, ensuring high predictability of earnings until the end of the current regulatory period in 2016.

In our view, ZSE's cash flow generation is strong, with EBITDA margins of about 60% (excluding pass-through costs for renewable energy generation). We view ZSE's profitability as comparable to its regulated peers in Western Europe, despite its regulatory framework allowing a relatively low cost of capital. Nevertheless, regulatory reset risk occurs every five years, with the next reset scheduled for 2017. In addition, the company has some exposure, albeit limited, to volume risk.

We believe short-term cash flow volatility owing to ZSE acting as conduit for the pass-through payments for renewable generation is a slight weakness, because it could temporarily pressure ZSE's liquidity and the company only recovers the payments over a two-year period. Nevertheless, we understand this volatility is likely to be mitigated by the introduction of a new tariff for all generators in 2014. A further uncertainty is the size of capital investments required to install smart meters, which could exceed the company's estimates of €20 million until 2020.

We view ZSE's supply business, which contributes about 15% of EBITDA on a normalized basis, as credit-dilutive. This is because of the supply business' inherent exposure to some price and demand risk. We anticipate that competition and, consequently, ZSE's customer switching rates will increase as the Slovakian market is gradually liberalized and price caps for residential customers and small and midsize enterprises are eventually abolished. That said, ZSE enjoys a dominant market position in its service area, a large and diversified customer base, and is gradually penetrating the gas supply market.

Our view of ZSE's financial risk profile as "significant" reflects its strong cash flow generation and limited investment requirements, which result in generally positive free operating cash flow (FOCF; after capital expenditure [capex]). We understand that ZSE's management intends to establish a leverage target (net debt to EBITDA) of 3.2x. In our base-case scenario, we project

that ZSE's Standard & Poor's-adjusted funds from operations (FFO) to debt will exceed 20% in the medium term. We forecast that ZSE's FFO to debt will reach its weakest point in 2014, due to higher payments to renewable energy generators and the loss of some large retail accounts. We project that FFO to debt should improve after 2015, mainly owing to a regulatory mechanism that allows ZSE to recover any overpayments to renewable energy generators with a two-year time delay.

Potential downside to our forecasts could arise from higher customer churn or a lower profit margin than we anticipate due to fiercer competition in electricity supply. Furthermore, we could see adverse consequences for ZSE's FFO to debt if the deficit due to renewable payments support is higher than we forecast, or is not compensated under regulatory mechanisms in a timely manner.

### **Liquidity**

We assess ZSE's liquidity as "strong" under our criteria. This reflects our view that ZSE's liquidity sources will exceed its liquidity needs by at least 1.5x over the next 12 months, and by at least 1.0x over the next 24 months.

ZSE's liquidity is supported by our forecast of strongly positive FOCF after capex. Furthermore, the company has two revolving credit facilities with terms of five years. We understand that ZSE's dividend policy aims to distribute all available cash flows, but has some flexibility to maintain leverage below 3.2x.

We understand that the new euro medium-term note program will not contain any covenants. At the same time, we see as a weakness that the company's liquidity credit facilities are subject to early repayment if the rating on ZSE falls to speculative grade. That said, we do not anticipate that ZSE will need to resort to these facilities. This is because in the normal course of its business, its cash flows more than adequately cover investment needs, and dividends are discretionary.

### **Outlook**

The stable outlook 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 dominant retail position in its service area and continue to acquire gas customers to offset any loss of electricity customers. We believe that adjusted FFO to debt above 20% is commensurate with the current SACP.

According to our methodology for GREs, a one-notch downward revision of the SACP to 'bbb' would not affect the corporate credit rating, assuming no change to our opinion of a "moderately high" likelihood of extraordinary state support.

Pressure on ZSE's SACP could arise if its credit metrics weaken, in particular if adjusted FFO to debt falls below 20%. This could occur if ZSE's actual operating or capital investment costs are higher than the regulator allows. More aggressive shareholder policies in terms of leverage tolerance and/or dividend payouts could also result in us revising the SACP on ZSE downward.

Rating upside could arise if ZSE is able to achieve and maintain adjusted FFO to debt of above 23% on a sustainable basis. However, we see this as unlikely in the medium term, in light of the company's leverage target and financial policies.

## Related Criteria And Research

- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2011
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

### New Ratings

Zapadoslovenska energetika a.s.

Corporate Credit Rating	BBB+/Stable/--
€1 Bil. Euro Medium-Term Note Program	BBB+

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