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Research Update:

Outlook On Slovakia-Based Utility Zapadoslovenska Energetika Revised To Positive; 'BBB+' Rating Affirmed

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Overview

- On Aug. 1, 2014, we revised our outlook on the Slovak Republic to positive from stable to reflect the increased likelihood of a more sustainable fiscal consolidation.
- In line with our criteria for rating government related entities, we are therefore revising to positive from stable the outlook on Slovakia-based, 51% state-owned, electricity distribution and supply company Zapadoslovenska Energetika a.s. (ZSE).
- At the same time, we are affirming our 'BBB+' long-term corporate credit rating on ZSE and our 'bbb+' assessment of its stand-alone credit profile (SACP).
- The positive outlook reflects the possibility that we could upgrade ZSE by one notch if we upgradeSlovakia by one notch, assuming that we maintain our view of state support as "moderately high," and that the SACP assessment remains the same.

Rating Action

On Aug. 7, 2014, Standard & Poor's Ratings Services revised to positive from stable its outlook on Slovakia-based, 51% state-owned, electricity distribution and supply company Zapadoslovenska Energetika a.s. (ZSE).

At the same time, we affirmed our 'BBB+' long-term corporate credit rating on ZSE.

Rationale

The outlook revision on ZSE follows the similar rating action we took on Slovakia on Aug. 1, 2014. The outlook revision on the sovereign was based on our view that the Slovak government's consolidation efforts will likely be boosted by broader economic growth, which will reduce its reliance on one-off measures (for more details, see "Outlook On Slovak Republic Revised To Positive On Likelihood Of More Sustainable Fiscal Consolidation; Ratings Affirmed"). In line with our methodology for rating government related entities (GREs), and based on our view that there is a "moderately high" likelihood that the state would provide extraordinary support to ZSE if needed, we could factor one notch of uplift into our ratings on ZSE, if we raised the rating on Slovakia to 'A+'.

We base our ratings on ZSE on its stand-alone credit profile (SACP), which we assess at 'bbb+', reflecting its "strong" business risk profile and "significant" financial risk profile. In accordance with our criteria for 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 the only electricity distribution operator in relatively wealthy western Slovakia. We believe that the regulatory framework--supervised by the independent regulator Slovak Regulatory Office for Network Industries (RONI)--is supportive and transparent, ensuring high predictability of earnings until the end of the current regulatory period in 2016. 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 merchant (price and demand) risk.

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 expenditures. We project that ZSE's adjusted funds from operations (FFO) to debt will exceed 20% in the medium term. Although we view the regulated distribution business as having relatively low volatility, we see the supply business as credit-dilutive and as a consequence, we use the medial volatility table.

We use positive comparable rating analysis to reflect our forecasts of ZSE achieving credit ratios at the upper end of the "significant" range. We view management and governance as "satisfactory."

Our base case assumes:

- Our forecast real GDP growth in Slovakia of 1.5% in 2014 and 2.0% in 2015.
- Regulatory visibility and high predictability of earnings until the end of the current regulatory period in 2016.
- The introduction of a new tariff from 2014 is sufficient to mitigate cash flow volatility due to pass-through payments for renewable generation.
- Increased competition and customer switch rate in the supply business will be compensated by the acquisition of gas customers.
- Investment in smart meters of about €20 million until 2020 as per the company's estimate.
- The dividend payout to maintain leverage as per the management's public target of (net debt to EBITDA) of 3.2x.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt above 20%.
- FFO interest coverage of 6x-7x.
- FOCF to debt of 8%-10%.

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.

We estimate that ZSE's principal liquidity sources over the next 12 months comprise:

- Access to unrestricted short-term cash of about €42 million as of June 30, 2014;
- Undrawn committed credit facilities of €20 million and €55 million maturing in September 2018 and August 2018, respectively; and
- Our forecast that ZSE will generate about €130 million of adjusted FFO.

We estimate that ZSE's principal liquidity uses over the next 12 months comprise:

- No short-term debt maturities;
- About €70 million-€80 million of capital investments; and
- Dividend payments, which aim to distribute all available cash flows, observing the leverage target of 3.2x.

We understand that the new Euro Medium-Term Note Program does 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 its investment needs, and dividends are discretionary.

Outlook

The positive outlook on ZSE reflects that on the Republic of Slovakia. In line with our methodology for rating GREs, and based on our view that there is a "moderately high" likelihood that the state would provide extraordinary support to ZSE if needed, we could factor one notch of uplift into our ratings on ZSE, if we raised the rating on Slovakia to 'A+'.

We could raise our assessment of ZSE's SACP if the company is able to achieve and maintain adjusted FFO to debt of above 23%. However, we see this as unlikely in the medium term, in light of the company's leverage target and financial policies.

We could revise the outlook to stable if we take a similar action on Slovakia. Pressure on ZSE's SACP could arise if the company's 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. Potential downside to our forecasts could also present itself if customer churn is higher, or the company's profit margin is lower, than we anticipate due to fiercer competition in the Slovak electricity supply sector. We could see adverse consequences for ZSE's FFO to debt if the deficit resulting from payments to renewable energy generators is higher than we forecast, or is not compensated under regulatory mechanisms in a timely manner. We could also revise downward our assessment of ZSE's SACP if the company adopts more aggressive shareholder policies in terms of leverage tolerance and/or dividend payouts.

According to our GRE methodology, a change in our assessment of the SACP by one notch to 'bbb' would not affect the corporate credit rating, assuming there is no change in our opinion of a "moderately high" likelihood of extraordinary support from the state.

Ratings Score Snapshot

Corporate credit rating: BBB+/Positive/--

Business risk: Strong

- Country risk: Intermediate
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral, Negative, Very negative (no impact)
- Liquidity: Strong, Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)
- Stand-alone credit profile: bbb+
- Sovereign rating: A/Positive/A-1
- Likelihood of government support: Moderately high (no impact)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - January 02, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - December 09, 2010
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

Related Research

- Outlook On Slovak Republic Revised To Positive On Likelihood Of More Sustainable Fiscal Consolidation; Ratings Affirmed, Aug. 1, 2014

Ratings List

	Ratings	
	To	From
Zapadoslovenska energetika a.s.		
Corporate credit rating		
Foreign and Local Currency	BBB+/Positive/--	BBB+/Stable/--
Senior Unsecured		
Foreign and Local Currency	BBB+	BBB+

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.