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Summary:
Zapadoslovenska energetika a.s.

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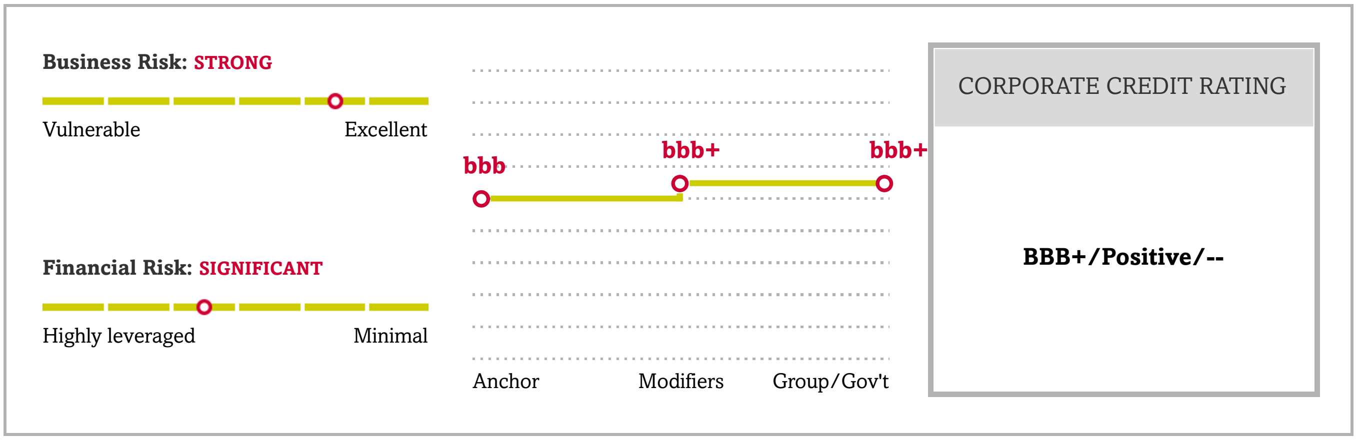
Summary:

Zapadoslovenska energetika a.s.



Rationale

Business Risk: Strong	Financial Risk: Significant
• Monopoly market position as the only electricity distribution operator in Western Slovakia. • Supportive and transparent regulatory framework ensuring high predictability of regulated earnings until 2016. • Strong operational performance. • Regulatory-reset risk every five years. • Non-regulated retail activities exposed to competition and merchant risk.	• Relatively high leverage. • Stable and predictable operating cash flows within regulatory periods. • Positive free operating cash flows. • Strong liquidity. • Relatively aggressive dividend policy.

Outlook: Positive

The positive outlook on Zapadoslovenska energetika a.s. (ZSE) reflects that on the Republic of Slovakia. 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 raise the rating on Slovakia to 'A+'.

We could also raise the rating on ZSE if we raise our assessment of its stand-alone credit profile (SACP) to 'a-'. We could consider doing this, if the company is able to achieve and maintain adjusted FFO to debt of above 23%.

Downside scenario

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 funds from operations (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 ratio 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.

Standard & Poor's Base-Case Scenario

In our base-case scenario, we project that ZSE's adjusted 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.

Assumptions

- Our forecast real GDP growth in the Slovak Republic 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.
- Investment in smart meters of about €23 million until 2020 as per the company's estimate.
- Lower gas supply margins due to the government's intervention in the sector since the acquisition of Slovenský plynárenský priemysel, a.s. (SPP),the key gas market player in Slovakia.
- A dividend payout that distributes all retained profits, although we understand there is an element of discretion in order to maintain credit quality.

Key Metrics

	2013A	2014E	2015E
FFO/debt (%)*	23.3%	20-22%	21-23%
Free operating cash flow/debt (%)*	12.3%	5-10	5-10

A--Actual. E--Estimate. *All figures are fully adjusted by Standard & Poor's. We make adjustments for operating leases, retirement obligations, and income from customer contributions.

Business Risk: Strong

Our assessment of ZSE's business risk profile as "strong" reflects the company's monopoly market position as the only electricity distribution operator in the relatively wealthy service area of western Slovakia. We arrive at an "intermediate" country risk assessment based on ZSE's cash flows being entirely derived from the Slovak Republic.

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 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. We anticipate that competition and, consequently, ZSE's customer switching rates, will increase as the Slovak market is gradually liberalized and price caps for residential customers and small 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.

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Financial Risk: Significant

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 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.

Liquidity: Strong

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.

Principal Liquidity Sources	Principal Liquidity Uses
• 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.	• No short-term debt maturities. • About €70 million-€80 million of capital investments; and • Dividend payments, which aim to distribute all available cash flows.

Covenants

We understand that the new Euro Medium-Term Note Program contains no covenants. At the same time, we see as a weakness ZSE's liquidity credit facilities being subject to early repayment if the rating on the company falls to speculative grade. That said, we do not anticipate that ZSE will need to resort to these facilities because, in the normal course of its business, its cash flows more than adequately cover its investment needs, and dividends are discretionary.

Other Modifiers

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."

Government Influence

We believe that there is a "moderately high" likelihood that the Slovak Republic would provide timely and sufficient extraordinary support to ZSE in the event of financial distress. 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 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 understand that the Ministry of Economy plans to establish an entity named Slovak Energy Holding, which will hold the remaining government stakes in Slovak energy companies, including the 51% stake in ZSE. We will monitor developments as this plan has yet to be fully formalized. We will maintain our treatment of ZSE as a GRE as long as we are confident that Slovak Energy Holding would act as a legal owner on behalf of the Slovak government with no business activities or cash extraction between subsidiaries.

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
- **Capital structure:** Neutral
- **Financial policy:** Neutral
- **Liquidity:** Strong
- **Management and governance:** Satisfactory
- **Comparable rating analysis:** Positive (+1 notch)

Stand-alone credit profile : bbb+

- **Related government rating:** A
- **Likelihood of government support:** Moderately high

Related Criteria And Research

Related Criteria

- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: February 2014, Feb. 11, 2014
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

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-

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