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Summary:
Zapadoslovenska energetika a.s.

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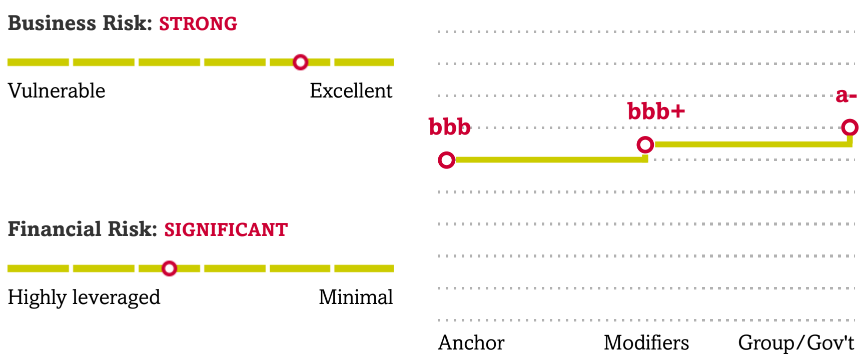

CORPORATE CREDIT RATING

A-/Stable/--

Rationale

Business Risk	Financial Risk
• 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. • Unregulated 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

The stable outlook on Zapadoslovenska energetika a.s. (ZSE) reflects the stable outlook on Slovakia. It also reflects Standard & Poor's Ratings Services' 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 ZSE's Standard & Poor's-adjusted funds from operations (FFO) to debt of above 20% is commensurate with the current stand-alone credit profile (SACP) of 'bbb+'.

Downside scenario

We could lower the rating on ZSE if we take a similar action on Slovakia, or if we revise ZSE's SACP down by one notch, assuming our view of extraordinary state support for ZSE remains unchanged.

ZSE's SACP could come under strain if its credit metrics weaken, in particular if adjusted FFO to debt falls below 20%. This could occur if ZSE's operating costs or capital investment costs are higher than the regulator allows. Higher customer turnover or a lower profit margin than we anticipate due to more fierce competition in the Slovak electricity supply sector could also weigh on credit metrics. 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 for under regulatory mechanisms in a timely manner. We could also revise ZSE's SACP downward if the company adopts more aggressive shareholder policies in terms of leverage tolerance or dividend payouts.

Upside scenario

We see an upgrade as unlikely, at present, because a higher rating on ZSE would require a three-notch upgrade of Slovakia or a two-notch upgrade of ZSE's SACP to 'a'. We could revise ZSE's SACP upward to 'a-' if the company is able to achieve and maintain adjusted FFO to debt of above 23%. According to our government-related entity (GRE) methodology, a one-notch change in the SACP would not affect the corporate credit rating.

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 2016, due to higher payments to renewable energy generators. We project that FFO to debt should improve after 2018, mainly owing to a regulatory mechanism that allows ZSE to recover any overpayments to renewable energy generators with a two-year time delay.

Assumptions

- Forecast real GDP growth in Slovakia of 3.0% in 2015 and 3.3% in 2016.
- Regulatory visibility and high predictability of earnings until the end of the current regulatory period ending in December 2016.
- Introduction of a new tariff from 2014, which is only partially mitigating cash flow volatility due to pass-through payments for renewable generation (30% of costs are covered by the generators). Full implementation delayed to 2017, where pass-through costs will be fully covered by generators.
- Investment in smart meters of about €23 million until 2020 as per the company's estimate.
- Gradually increasing gas supply margin through acquisition of new customers to offset losses in power supply in the medium term.
- Dividend payout which distributes all retained profits, although we understand there is an element of discretion in order to maintain credit quality.

Key Metrics

	2014A	2015E	2016E
FFO/debt (%)	22.2	21.0-23.0	19.0-21.0
FOCF/debt (%)	10.2	5.0-10.0	5.0-10.0

All figures fully adjusted by Standard & Poor's. We make adjustments for operating leases, retirement obligations, and income from customer contributions. FFO--Funds from operations. FOCF--Free operating cash flow. A--Actual. E--Estimate.

Business Risk

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 assess country risk as "intermediate" based on ZSE's cash flows being entirely derived from Slovakia.

We believe that the regulatory framework--supervised by the independent regulator Slovak Regulatory Office for Network Industries--is supportive and transparent, ensuring high predictability of earnings through to the end of the current regulatory period in December 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 to volume risk, albeit limited.

We view ZSE's supply business, which contributes about 10% of EBITDA on a normalized basis, as a negative credit factor. 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 Slovakian market is gradually liberalized. However, we do not expect price caps for residential customers and small enterprises to be abolished in the medium term. ZSE enjoys a dominant market position in its service area, a large and diversified customer base, and is gradually penetrating the gas supply market.

Financial 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 (capex). We project that ZSE's adjusted FFO to debt will exceed 20% in the medium term. We view the regulated distribution business as having relatively low volatility, but owing to the merchant risk associated with the supply business, we use the financial ratio benchmarks associated with a medial volatility industry in our analysis.

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.

Principal Liquidity Sources

- Access to unrestricted short-term cash of about €90 million as of June 30, 2015;
- Undrawn committed credit facilities of €55 million and €20 million maturing in August 2018 and September 2018, respectively; and
- Forecast adjusted FFO of about €130 million.

Principal Liquidity Uses

- No short-term debt maturities;
- About €70 million-€80 million in capital investments; and
- Dividend payments, which aim to distribute all available cash flows.

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.

Covenants

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

Other Modifiers

We forecast ZSE to achieve credit ratios at the upper end of the range for a "significant" financial risk profile. We therefore incorporate one notch of uplift in the rating under our positive comparable rating analysis modifier. We view management and governance as "satisfactory."

Government Influence

We believe that there is a "moderately high" likelihood that Slovakia 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 through the Ministry of Economy. 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.

Ratings Score Snapshot

Corporate Credit Rating

A-/Stable/--

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 (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Positive (+1 notch)

Stand-alone credit profile : bbb+

- **Likelihood of government support:** Moderately high (+1 notch from SACP)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 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

- Slovak Republic Long-Term Ratings Raised To 'A+' On Accelerating Growth; Outlook Stable, July 31, 2015

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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