

# RatingsDirect®

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## Summary:

# Zapadoslovenska energetika a.s.

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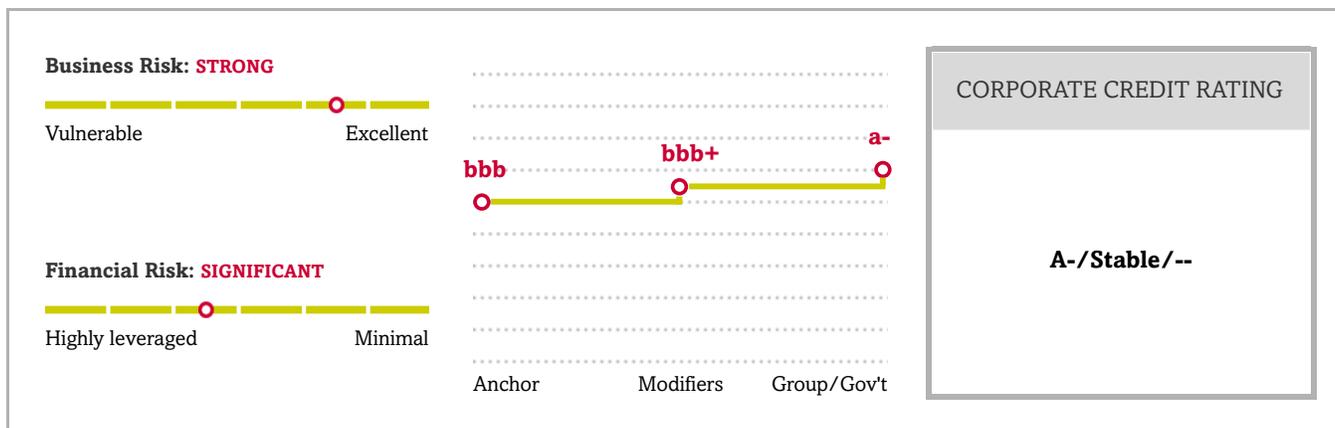
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## Summary:

# Zapadoslovenska energetika a.s.



## Rationale

Business Risk: Strong	Financial Risk: Significant
<ul style="list-style-type: none"> <li>• Monopoly market position as the only electricity distribution operator in Western Slovakia.</li> <li>• Vast majority of stable and predictable cash flows from low-risk regulated distribution network operations.</li> <li>• Strong operational performance.</li> <li>• Regulatory-reset risk at its highest ahead of new regulatory period starting in 2017.</li> <li>• Unregulated retail activities exposed to competition and merchant risk.</li> </ul>	<ul style="list-style-type: none"> <li>• Relatively high leverage.</li> <li>• Stable and predictable operating cash flows within regulatory periods.</li> <li>• Positive free operating cash flows.</li> <li>• Strong liquidity.</li> <li>• Relatively aggressive dividend policy.</li> </ul>

## Outlook: Stable

The stable outlook on Zapadoslovenska energetika a.s. (ZSE) reflects the stable outlook on Slovakia. It also reflects S&P Global Ratings' view of continued stable and predictable earnings and cash flows from what we see as ZSE's relatively low-risk, regulated distribution business.

We 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 S&P Global Ratings-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 downward 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 fiercer 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 upward revision 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.

## Our Base-Case Scenario

In our base-case scenario, we project that ZSE's adjusted FFO to debt will exceed 20% in the medium term, but will see some volatility due to payments to renewable energy generators. That said, the regulatory mechanism in Slovakia allows ZSE to recover any overpayments to renewable energy generators within two years.

Assumptions	Key Metrics			
<ul style="list-style-type: none"> <li>Forecast real GDP growth in Slovakia of 3.0% in 2016 and 2.7% in 2017.</li> <li>Regulatory visibility and high predictability of earnings in the new regulatory period from 2017 to 2021, based on the same price-cap mechanism as in the previous regulatory period.</li> <li>Above 90% EBITDA from the regulated distribution business until the end of next regulatory period in 2021.</li> <li>Likely transferal of responsibility for renewable energy generation support to the central buyer (OKTE) from the distribution system operators, which will mitigate cash flow volatility from 2019.</li> <li>Investment in smart meters of about €23 million until 2020, as per the company's estimate.</li> <li>Dividend payout that distributes all retained profits, although we understand there is an element of discretion in order to maintain credit quality.</li> </ul>	<b>2015A</b>	<b>2016E</b>	<b>2017E</b>	
	FFO/debt (%)	23.1	21.0-23.0	20.0-22.0
	FOCF/debt (%)	10.5	8.0-12.0	8.0-12.0
<p>All figures fully adjusted by S&amp;P Global Ratings. 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.</p>				

## 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 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. We expect that the new regulatory period commencing in January 2017 will be based on the same price-cap mechanism as in the previous regulatory period, and will remain supportive and transparent.

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 that of 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 less than 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: 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 (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: Strong

Our assessment of ZSE's liquidity as strong 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 RCFs with terms of five years. We understand that ZSE's dividend policy aims to distribute all available cash flows.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"><li>• Access to unrestricted short-term cash of about €112 million as of June 30, 2016;</li><li>• Undrawn committed credit facilities (RCFs) of €55 million and €20 million maturing in August 2018 and September 2018, respectively; and</li><li>• Forecast adjusted FFO of about €130 million.</li></ul>	<ul style="list-style-type: none"><li>• No short-term debt maturities;</li><li>• About €70 million-€80 million in capital investments; and</li><li>• Dividend payments that aim to distribute all available cash flows.</li></ul>

## Covenants

We understand that the euro medium-term note program does not contain any covenants. At the same time, we see as a weakness the fact that ZSE'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 because its cash flows are normally more than adequate to cover investment needs, and dividends are discretionary.

## Other Modifiers

We forecast that ZSE will 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

<b>Business And Financial Risk Matrix</b>						
<b>Business Risk Profile</b>	<b>Financial Risk Profile</b>					
	Minimal	Modest	Intermediate	<b>Significant</b>	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
<b>Strong</b>	aa/aa-	a+/a	a-/bbb+	<b>bbb</b>	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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