S&P Global
Ratings

RatingsDirect®

Research Update:

Slovak Utility Zapadoslovenska Energetika 'A-' Ratings Affirmed On Solid Financial Performance; Outlook Stable

Primary Credit Analyst:
Renata Gottliebova, London +44 20 7176 1257; renata.gottliebova@spglobal.com

Secondary Contact:
Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@spglobal.com

Table Of Contents

Research Update:

Slovak Utility Zapadoslovenska Energetika 'A-' Ratings Affirmed On Solid Financial Performance; Outlook Stable

Overview

- Slovakia-based electricity distribution and supply company Zapadoslovenska energetika a.s. (ZSE) continues to post solid financial performance.
- We continue to see a moderately high likelihood of extraordinary government support to ZSE in the event of financial distress.
- We are affirming our 'A-' long-term rating on ZSE.
- The stable outlook reflects the stable outlook on Slovakia. It also encompasses our view that ZSE will maintain headroom under its cash flow coverage ratios, namely funds from operations to debt of above 18%.

Rating Action

On Sept. 27, 2017, S&P Global Ratings affirmed its 'A-' long-term corporate credit rating on Slovakia-based, 51% state-owned electricity distribution and supply company Zapadoslovenska energetika a.s. (ZSE). The outlook is stable.

We also affirmed our 'A-' issue rating on ZSE's senior unsecured debt.

Rationale

The affirmation reflects ZSE's continued solid financial performance, resulting in credit measures well in line with our expectations for the ratings. We now forecast funds from operations (FFO) to debt of around 25% until the end of the current regulatory period (2021), leading us to revise ZSE's financial risk profile to intermediate from significant. We have, however, revised down our liquidity assessment on ZSE to adequate from strong due to the company's large refinancing need in October 2018, when a €315 million bond matures. Although we expect the bond refinancing to take place at least six months ahead of its maturity, we view the large refinancing need (about 50% of total outstanding debt) as slightly negative on a comparable ratings basis, and we therefore continue to asses ZSE's stand-alone credit profile (SACP) at 'bbb+'.

ZSE is the sole distribution operator in the relatively wealthy service area of western Slovakia and also has a dominant position as electricity supplier in the same region. In 2016, ZSE derived 95% of EBITDA from its regulated activities and the remaining 5% from electricity and gas supply activities. At year-end 2016, ZSE posted €195 million of EBITDA and adjusted net debt of €570 million.

The key credit factor underpinning the ratings is the supportive and predictable regulatory framework for electricity distribution companies in Slovakia. We believe that the five-year regulatory framework--supervised by the independent regulator RONI (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 2021. The framework is based on a fairly traditional price-cap mechanism and the allowed profits are based on weighted-average cost of capital (WACC; currently 6.47% for 2017 and reset every year) determined by the regulator and the regulatory asset base. Nevertheless, regulatory reset risk occurs every five years with the next reset scheduled for 2021, therefore the reset risk is at its lowest.

We believe short-term cash flow volatility owing to ZSE's role as conduit for the pass-through payments for renewable generation is a slight weakness. This is because it could temporarily weigh on ZSE's liquidity and the company only recovers the payments over a two-year period. Nevertheless, we understand this volatility will diminish from 2019 as these payments are expected to be transferred to the central payer by the end of 2017.

We see ZSE's supply business, which contributed around 5% of EBITDA in 2016, as more credit-dilutive due to its inherent exposure to merchant risk. That said, we understand that the supply business has been stable in recent years as there is no fierce competition--unlike in Western Europe--and churn rates have been very low.

Due to the organic growth and increased electricity consumption in Western Slovakia, we now forecast that ZSE's distributed volumes will increase until the end of the current regulatory period. We believe that this will also support stronger credit ratios than previously anticipated. We now forecast FFO to debt at 25%, on average, for the next three years, compared with our previous forecasts of 22%. We also see as positive that the overall share of low–risk regulated activities has been increasing and now represents 95% of ZSE's total EBITDA. We have therefore lowered the threshold for an appropriate FFO to debt ratio for the company's 'bbb+' SACP to above 18% from above 20%. The financial risk profile also benefits from ZSE's strong cash flow generation and limited investment requirements, which result in generally positive free operating cash flow (FOCF; after capital expenditure [capex]).

Our base case assumes:

- WACC is set at 6.47% for 2017 and is reset every year.
- We assume continued regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2021).
- Our expectation of lower EBITDA for 2018 driven by one-off outages in selected renewable producers' generation in 2017. From 2019 onwards, stable EBITDA reflects the expected renewable support deficit to be shifted to a dedicated central payer (OKTE), which will mitigate cash

flow volatility. No renewable support deficit is assumed after 2019.
- Investment plan supported by organic growth (mainly network enhancements projects) is expected to increase from current low levels (around €80 million).
- Dividend payout that distributes all retained profits, although we understand there is an element of discretion in order to maintain credit quality.
- Successful refinancing of a €315 million bond at least six months ahead of scheduled maturity (October 2018) at a lower interest cost.

Based on these assumptions, we arrive at the following credit measures:
- FFO to debt, on average, of 25% for the next two to three years.
- Positive FOCF to debt to remain around 10%.
- Debt to EBITDA of 2.8x-3.2x for the next two to three years.

We continue to view that there to be a moderately high likelihood of extraordinary government support from Slovakia to ZSE if needed, based on 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.

Liquidity

We assess the company's liquidity as adequate, albeit supported by qualitative factors. In our view these include: ZSE's solid relationships with banks; the company's high standing in credit markets; the ongoing benefit of its state ownership; and prudent financial policy. On this basis, we expect annual cash flow generation, the group's cash position, and committed credit facilities will cover expected cash outlays--mainly capex and dividends--by more than 1.1x over the next 12 months. We also forecast that sources will cover uses even if EBITDA declined by 10%.

We anticipate the company will have the following principal liquidity sources over the next 12 months:
- Access to unrestricted short-term cash of about €65.8 million as of June 30, 2017;
- Undrawn committed credit facilities of €20 million and €55 million both maturing in October 2018; and
- Our forecast that ZSE will generate above €130 million of adjusted FFO.

We anticipate the company will have the following principal liquidity uses over the same period:
- No short-term debt maturities before €315 million bond matures in October 2018, which we understand are in the process of being prolonged;
- About €80.0 million of capital investments; and
- Dividend payments that aim to distribute all available cash flows.

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 is lowered 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.

Outlook

The stable outlook on ZSE reflects the stable outlook on Slovakia. It also 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. We believe that ZSE's S&P Global Ratings-adjusted FFO to debt of above 18% is commensurate with the current ratings.

Upside scenario

We see an upgrade as unlikely, at present, unless there is a strengthening of both Slovakia's rating and ZSE's SACP.

We could revise ZSE's SACP upward to 'a-' if the company successfully executes its upcoming bond refinancing and is able to maintain adjusted FFO to debt of above 23%.

Downside scenario

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

ZSE's SACP could come under strain if, for example, there were any unexpected negative changes to the regulatory framework, if the deficit resulting from payments to renewable energy generators were not compensated for under regulatory mechanisms in a timely manner, or if ZSE's operating costs or capital investment costs are higher than the regulator allows. We could also lower the SACP if ZSE's credit metrics weakened, in particular if adjusted FFO to debt fell below 18% without any prospects for recovery. This could occur if the company adopted more aggressive shareholder policies in terms of leverage tolerance or dividend payouts. We could lower the SACP if ZSE failed to address its 2018 refinancing at least six months in advance.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/--

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb+
- Sovereign rating: A+
- Likelihood of government support: Moderately high (+1 notch)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

```
Ratings Affirmed

Zapadoslovenska energetika a.s.
 Corporate Credit Rating                A-/Stable/--
  Senior Unsecured                      A-
```

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com