FitchRatings

Fitch Affirms ENEA at 'BBB' On Bogdanka Acquisition

Fitch Ratings-Warsaw/London-29 October 2015: Fitch Ratings has affirmed Poland-based ENEA S.A.'s Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'BBB' and National Long-term rating at 'A(pol)' with Stable Outlooks.

The affirmation reflects our expectation that ENEA's credit metrics will remain within guidance for the rating, despite the company's acquisition of a 64.57% stake in coal mining company Lubelski Wegiel Bogdanka S.A. (Bogdanka) for PLN1.48bn (EUR0.35bn), and lower expected WACC in electricity distribution from 2016 negatively affecting ENEA's profitability. The acquisition of Bogdanka increases ENEA's vertical integration and reduces the coal supply and coal price risks to its generation division as Bogdanka is ENEA's main coal supplier. However, the acquisition also changes ENEA's business profile by reducing the share of the more predictable and fairly stable regulated electricity distribution at the expense of risky and cyclical coal mining.

Our updated projections show funds from operations (FFO) adjusted net leverage increasing to about 3x in 2017-2019 on the back of the large capex plan from 0.7x in 2014. We view net leverage of 3x as a maximum level for the current ratings. Any additional acquisitions of coal mining companies increasing leverage or leading to a weaker business profile of the group would be negative for ENEA's ratings.

KEY RATING DRIVERS

Bogdanka Acquisition
After the acquisition of a 64.57% stake in Bogdanka, ENEA will own 66% of the coal mining company and will have management control. The acquisition will be closed in the next few days. Bogdanka is the most modern coal mine in Poland and one of only a few that are profitable in the current stressed environment, pressured by long-term low coal prices and overcapacity in the Polish market. Bogdanka has a 13.5% share in the sale of coal to the electricity sector in Poland.

The acquisition of Bogdanka is a large transaction for ENEA (the acquisition price of PLN1.48bn compared with ENEA's EBITDA of PLN1.8bn in 2014). Bogdanka has low leverage - the company's net debt to EBITDA was 0.8x at end-2014. In 1H15 Bogdanka's EBITDA fell by 4% to PLN292m while its coal production decreased by 8.5% due to the lower coal prices and oversupply in the Polish coal market. ENEA confirmed it will maintain Bogdanka's dividend policy after the acquisition, which will lead to a dividend leakage to minority shareholders and reduces Fitch-calculated FFO.

Strong Business Links with Bogdanka
Both companies have strong business links as Bogdanka is the main coal supplier of ENEA (71% of total supplies in 2014) while ENEA is the main coal off-taker for Bogdanka. Bogdanka's coal production is higher than ENEA's needs (9.2m tonnes vs. 5.5m tonnes in 2014) and as a result about 60% of Bogdanka's production is sold to other customers. With ENEA's increasing electricity production from 2017-2018 due to the commissioning of a new 1GW unit in Kozienice, ENEA's needs should be fairly well matched with Bogdanka's production volumes.

Changed Business Profile
The acquisition of Bogdanka increases ENEA's vertical integration and reduces the risk of coal supply and coal price to its generation segment. However, the acquisition also changes ENEA's business profile by reducing the share of the more predictable and fairly stable regulated electricity distribution due to the increased contribution of risky and cyclical coal mining. We project that after the acquisition, Bogdanka will generate 23% of ENEA's consolidated 2016 EBITDA based on full consolidation. The Bogdanka acquisition and lower WACC in distribution from 2016 will decrease the share of regulated distribution to 46% of total EBITDA in 2016 from 61% of EBITDA in 2014.

We assume that electricity distribution has lower business risk than generation and coal mining and higher debt capacity and can support FFO adjusted leverage of about 5x for the 'BBB' rating category. We assume that generation supports leverage of about 2x and Bogdanka's mining about 1x. Given the weighting of the three main business segments in ENEA's EBITDA the negative guideline for the rating is FFO adjusted net leverage of 3x.

Lowered Remuneration in Distribution
We project that the lower WACC for 2016 will reduce ENEA's EBITDA from the regulated distribution business by PLN110m in 2016 (or 5% of total EBITDA). The regulator has recently reduced WACC for 2016 to 5.28% from 7.2% for 2015 (or from 6.84% when incorporating a 5% reduction of return by the regulator). The WACC reduction is partly due to a decrease in market interest rates. We assume that WACC will gradually increase to 5.6% in 2019. The regulatory return for distributors could also be negatively affected from 2018 by quality elements in the tariff system for 2016-2020. Failure to achieve quality thresholds, for instance with regards to average interruption duration and interruption frequency of distribution services, may reduce returns on the regulatory asset base by up to 15% or up to 2% of regulated revenue.

Potential Support for Coal Mining
The government's support plan for the domestic coal mining sector, which is facing financial difficulties, includes the acquisition of stakes in some loss-making coal mining companies by state-controlled utilities, and a broader consolidation of the electricity and coal mining sectors to support the mines' financial and liquidity position. Our rating case for ENEA includes only the acquisition of Bogdanka. In our view, further acquisitions of interests in coal mines, or other forms of support for the coal mining sector resulting in net leverage above 3x or substantially weakening ENEA's business profile would be negative for the ratings.

We believe that the Polish coal mining sector has a substantially higher business risk profile than the electric utilities sector due to its high employment and high cost base combined with the drop in international and domestic coal prices.

The 25 October elections resulted in a change in government, which may lead to changes in the state's strategy towards the electricity and coal mining sectors.

Challenging Generation Environment
Fitch expects the electricity generation segment to remain under pressure in 2016-2017 due to low wholesale electricity prices, declining free CO_2 allowances, rising prices of CO_2 and a rising share of renewables supported by subsidies. In addition, the compensation scheme for the termination of long-term power purchase agreements concluded for ENEA in 2014 will end, with the final PLN294m (EUR69m) adjustment for compensation received in 2015. As a result, cash flows in conventional generation will not be supported by the compensation scheme from 2016.

The impact of a challenging environment for fossil-fuel generation is mitigated by ENEA's ongoing savings programme focused on the generation and distribution segments. We do not view the structural change in the Polish generation market as rapid and far-reaching as in Germany and highlight that interconnections are also only gradually improving, giving domestic players time to adjust.

Limited Diversification of Generation Sources
ENEA's business profile is constrained by its lack of generation fuel mix diversification and high asset concentration (over 90% of generation is coal-fired and produced in the Kozienice plant). ENEA also has substantial exposure to CO_2 costs as free CO_2 allowances in Poland are being gradually phased out between 2013-2020.

Large Capex to Increase Leverage
ENEA's capex plan for 2014-2020 amounts to PLN20bn, of which PLN11.8bn relates to core capex for conventional power generation (including a new 1GW unit in the Kozienice coal-fired power plant)

and the distribution segment, while PLN7.7bn is allocated to new projects for instance in renewables and cogeneration of heat and power. We understand from management that most of new projects in the capex plan are discretionary, depending on cash flow generation and credit metrics, including financial covenants incorporated in some debt funding agreements.

Our rating case projections assume that ENEA's capex will be PLN13.7bn for 2015-2019 including PLN1.48bn on the Bogdanka acquisition.

According to our projections, ENEA's large capex including the Bogdanka acquisition will increase FFO adjusted net leverage to about 3x in 2017-2019 from 0.7x in 2014. We view net leverage of 3x as a maximum level for the current ratings.

Rated on a Standalone Basis
ENEA is 51.5%-owned by the Polish state (A-/Stable). However, Fitch rates ENEA on a standalone basis and does not factor in rating uplift from state ownership. The company operates on a commercial basis and we assess legal, operational and strategic links with the state as moderate, in line with the Parent and Subsidiary Rating Linkage criteria.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- No major shifts in wholesale electricity prices within the forecast period
- An increase in CO2 market price of around 50% up to 2019
- Increased electricity production volumes from mid-2017, due to commissioning of the 1GW Kozienice new block
- Stable distribution and sales volumes
- Lower WACC in the distribution segment from 2016: 5.3% in 2016 and then gradual increase to 5.6% in 2019
- Capex of about PLN13.7bn in 2015-2019 including PLN1.48bn on the Bogdanka acquisition

RATING SENSITIVITIES
Rating upside potential for ENEA is limited given the company's large capex plan, business risk profile including a large portion of mining and our expectation that FFO net adjusted leverage will increase close to the 3x limit for the ratings in 2017-2019. However, future developments that could lead to positive rating action include:
- Stronger than expected cash flow generation and/or reduction of the capex plan leading to projected FFO net adjusted leverage below 2x on a sustained basis, supported by management's more conservative leverage target.
- A more diversified fuel generation mix and lower CO2 emissions per MWh which, together with continued efficiency improvements, would result in a stronger business profile.

Negative: Future developments that could lead to negative rating action include:
- Increase in FFO adjusted net leverage to above 3x on a sustained basis - for example, due to full implementation of the PLN20bn capex plan for 2014-2020 in a scenario of low operating cash flows.
- Substantial adverse change in ENEA's business profile, such as a material reduction in the share of regulated distribution in total EBITDA.
- Additional acquisitions of stakes in coal mines or other form of support for the coal mining sector - which is facing financial difficulties - leading to net leverage above 3x or substantially worsening ENEA's business profile.
- Prolonged oversupply in the Polish coal market, driven by artificially maintained production levels at unprofitable mines, leading to substantially weaker cash flows of Bogdanka.

LIQUIDITY
Liquidity is sufficient. At end-June 2015, the company had PLN1.9bn of unrestricted cash and equivalents and available credit lines and committed bonds of PLN4.2bn against short-term debt of PLN109m. Fitch projects negative free cash flow of about PLN1bn in 2016.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

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