ENEA S.A. (/gws/en/esp/issr/90421075)

FitchRatings

Fitch Affirms ENEA at 'BBB'; Outlook Stable

Fitch Ratings-Warsaw/London-30 November 2016: Fitch Ratings has affirmed Poland-based ENEA S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings at 'BBB' and National Long-Term Rating at 'A+(pol)' with Stable Outlooks.

The affirmation reflects the high contribution of regulated electricity distribution business, which has good cash flow visibility, to ENEA's EBITDA. We project funds from operations (FFO) adjusted net leverage to rise to about 3x in 2017-2019 due to the large planned capex, from 1.9x in 2015. We view FFO adjusted net leverage of 3x as a maximum for the current ratings. Any additional debt-funded acquisitions above the existing capex plan would be negative for ENEA's ratings if leverage is above 3x.

KEY RATING DRIVERS
Distribution Supports Credit Profile
ENEA's creditworthiness benefits from a high EBITDA contribution from regulated electricity distribution (47% of 9M16 EBITDA), which has lower business risk and better cash flow predictability than conventional generation and coal mining. The acquisition of coal mining company Lubelski Wegiel Bogdanka S.A. in 4Q15 reduced distribution's contribution to EBITDA to about 45% in 2016-2018 from close to 60% in 2014. The acquisition of Bogdanka increased ENEA's vertical integration and reduced the risk of coal supply and coal price to its generation activities, although it also increased its focus on single technology.

Capex Focus on Conventional Power
About 50% of 2016-2017 capex is allocated to conventional power generation, mostly completion of the Kozienice 1.1GW coal-fired power plant. In this period distribution will account for 33% of capex, but with the completion of the Kozienice project it will take up more than 50% of capex from 2018.
ENEA's new strategy, published in September 2016, assumes further investments in conventional power generation (construction of new power plants and acquisitions) to add 1.5GW-2GW of capacity by 2025. Some of these projects will be implemented in partnerships with other electric utilities.

Ostroleka C Project Increases Business Risks
In our view, ENEA's possible involvement in a partnership to build a 1GW coal-fired power plant, Ostroleka C, increases business risks for the company due to weak market conditions for conventional power generation. The final investment decision on the construction of the Ostroleka C plant may be taken in 2018 and commissioning is planned for 2023. However, implementation of Ostroleka C without a new capacity market mechanism would be negative for ENEA's rating.

Challenging Generation Environment
Fitch expects the electricity generation segment to remain under pressure in 2017-2018 due to low wholesale electricity prices and declining free carbon dioxide (CO_2) allowances. Since 2014 ENEA has benefited from payments from the Operational Capacity Reserve, but we do not include any cash inflows related to the proposed capacity market in our rating case forecast until 2020.

Large Capex to Increase Leverage
The company's strategy assumes that implementation of the capex plan and acquisitions will be subject to ENEA's maintenance of net debt/EBITDA at a safe level, below debt covenants. We assume no dividend payments for 2017-2020 in our rating case, with capex of about PLN11bn in 2016-2020, including cash outflows for the Ostroleka C project in the initial phase (most of Ostroleka C's capex would be spent in 2021-2023). With these assumptions, we do not expect a covenant breach or the leverage to be above the rating sensitivity.

M&A Risk
ENEA has placed a number of non-binding bids for generation assets and is considering further investment in coal mining. These potential acquisitions may be rating negative for ENEA depending on size, business fit and resulting credit metrics.

Rated on a Standalone Basis
ENEA is 51.5% owned by the Polish state (A-/Stable). However, Fitch rates ENEA on a standalone basis because we assess legal, operational and strategic links with the state as moderate under our Parent and Subsidiary Rating Linkage criteria. In our view, the links have had an incrementally greater impact on the company under the new government, in office since November 2015. Examples include a less-generous dividend policy - the company did not pay dividends in 2016 compared with a PLN207m dividend in 2015 - and also possible support for coal mining.

DERIVATION SUMMARY
ENEA's creditworthiness benefits from a high share of regulated electricity distribution in EBITDA (about 45% in 2016-2018), although this is lower than for Energa S.A (BBB/Stable) and TAURON Polska Energia S.A. (BBB/Stable). This translates into a tighter leverage guideline for ENEA than for Energa and Tauron. ENEA's business profile is constrained by its lack of generation fuel mix diversification and high asset concentration in power generation.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Weighted average cost of capital in the distribution segment reduced to 5.7% in 2016 from 7.2% in 2015 (and 6.8% when applying the one-off haircut applied by the regulator), before gradually increasing to 6% in 2020
- 5% haircut reducing return on the distribution's regulated asset base incorporated from 2018
- Wholesale baseload power prices falling to about PLN155 per megawatt-hour by 2019-2020
- Capex of around PLN11bn in 2016-2020, including cash outflows for the Ostroleka C project in the initial phase (most of Ostroleka C's capex would be spent in 2021-2023)
- No dividends in 2017-2020.

RATING SENSITIVITIES
Positive: Rating upside potential for ENEA is limited due to the company's large capex plan, business risk profile including a large portion of mining and our expectation that FFO adjusted net leverage will increase 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 capex and acquisition plans leading to projected FFO adjusted net leverage sustained below 2x, supported by management's more conservative leverage target;
- a more diversified fuel generation mix and lower CO_2 emissions per megawatt-hour, 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 or FFO fixed charge cover below 5x on a sustained basis due, for example, to full implementation of the capex plan or acquisitions in a scenario of low operating cash flows or prolonged oversupply in the Polish coal market;
- substantial adverse change in ENEA's business profile, such as a material reduction in the share of regulated distribution in total EBITDA;
- a substantial tax payment arising from an increase in the nominal value of ENEA's shares. This is a cash flow and operating environment risk for ENEA and other Polish state-controlled utilities as the government contemplates an increase of the nominal value of their shares. Such an increase would be subject to approval at the shareholders' meeting. This tax payment is not included in our assumptions for the rating case. We treat this as event risk and a potential corporate governance issue.

LIQUIDITY
Adequate Liquidity

At end-September 2016 ENEA had Fitch-calculated readily available cash of PLN2.2bn against short-term debt of PLN0.1bn. ENEA's committed financing at end-September 2016 totalled PLN3.3bn. We project negative free cash flow of PLN1.2bn for 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
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016) (https://www.fitchratings.com/site/re/885629)
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016) (https://www.fitchratings.com/site/re/886557)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1015557&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJzZXNzaW9uS2V5IjoiNzZLRE1HTFRCQVhRM1hQNkZYNlMyRkJPNjZPTENPTkJRWjhZV0xBUyIsImV4cCI6MTQ4MTA5OTE5MCwidXNlckIkIjoyMzY3NDc5fQ.tNbFmbPTx5XHwnYklH_X9yIE20h6IO82OodXYLOO-pM)
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