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

FitchRatings

Fitch Affirms ENEA at 'BBB'; Outlook Stable

Fitch Ratings-London/Warsaw-30 June 2017: Fitch Ratings has affirmed Poland-based ENEA S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings at 'BBB' with Stable Outlooks. Fitch has also affirmed and simultaneously withdrawn ENEA's National Long-Term Rating of 'A+(pol)' with a Stable Outlook for commercial reasons.

The affirmation follows the completion of capital investments in 2017. These include the acquisition of power generation company ENGIE Energia Polska S.A. (ENGIE Poland) as well as minority investments in coal mining company Polska Grupa Gornicza Sp. z o.o. (PGG) and construction company Polimex-Mostostal S.A. These investments reduced the importance of more predictable power distribution income in ENEA's business profile and increased net leverage, which is negative for the credit profile. However, the impact of the largest acquisition, ENGIE Poland, is mitigated by refurbishment of the power blocks prior to acquisition, their profitability and reasonable consideration paid.

We project funds from operations (FFO) adjusted net leverage to rise to about 3x in 2017-2019 from 2.2x in 2016 on the back of these capital investments and large capex. We anticipate that FFO adjusted net leverage will not exceed 3x, which provides the foundation for our affirmation of the ratings, but leaves no headroom within their current level.

KEY RATING DRIVERS

ENGIE Poland Acquisition: ENEA acquired 100% of ENGIE Poland for an enterprise value of PLN995 million (EUR231 million) in March 2017. The main asset of ENGIE Poland is a 1.9GW power plant (1.7GW coal-fired, 0.2GW biomass-fired) located in Polaniec. In 2016 the plant produced 10TWh of electricity and had EBITDA before proceeds from the sale of CO2 allowances of PLN286 million (EUR68 million).

Negative Impact Mitigated: The acquisition of ENGIE Poland is mildly negative for ENEA's credit profile due to the increase in importance of conventional generation in ENEA's EBITDA and hard coal in its fuel mix. However, the negative impact is mitigated by refurbishment of the power blocks prior to acquisition, their profitability and reasonable consideration paid (EV/EBITDA multiple of 3.5x).

Investments Viewed as Cash Outflows: ENEA currently has no further acquisitions planned following its 2017 PLN300 million acquisition of 7.7% shares in coal mining company PGG as well as the PLN78 million acquisition of a 16.5% stake in construction company Polimex-Mostostal. Fitch views the PGG investment as negative for ENEA's credit profile due to increased exposure to coal mining, questionable returns and risk of participation in future equity increases at PGG, if any. The Polimex-Mostostal investment is smaller and it reduces ENEA's construction risk on the Kozienice power plant project.

We treat both investments as pure cash outflows increasing net leverage and do not assume they will bring any tangible returns.

Ostroleka C Project: ENEA is considering participation in the construction of the new coal-fired block in Ostroleka together with Energa S.A. (BBB/Stable) with the possible involvement of third-party investors. The exact structure and budget of the project are unknown at this point, but ENEA has agreed to participate in the preparatory works. The company is entitled to withdraw from the project until the final decision to construct is taken (probably in 2018) if the project turns out to be unprofitable or lead to breach of ENEA's bank covenants.

High, but Manageable Leverage: In our rating case forecasts we assume suspension of dividends from 2018, but include cash outflows for the Ostroleka C preparatory and initial construction phase resulting in total capex and acquisitions of about PLN12bn in 2017-2021. In our rating case, FFO adjusted net leverage stays at 3x leaving no headroom within the current ratings. Assuming ENEA withdraws from the Ostroleka C project following the 2017-2018 development phase and continues paying dividends at the 2017 level (PLN110 million), its FFO adjusted net leverage should decrease to slightly below 3x.

Power Capacity Market Coming: We view plans by the Polish government to introduce a capacity market as positive for ENEA's ratings. Assuming the Capacity Market Act is approved by the Polish parliament and receives notification from the EU Commission by the end of 2017, the first capacity auctions could be announced in 2018 with first cash inflows in 2021. We currently do not include any inflows related to the capacity market in our rating case.

Power Distribution Less Important: The ENGIE Poland acquisition and start of operations of the new 1GW block in Kozienice will double the power generation volume in ENEA and maintain a high share of generation in its EBITDA. With the acquisition of the Bogdanka mine in 2015 a considerable part of EBITDA will come from mining. Power distribution will decline to 40% to 45% of EBITDA in 2017-2021, from the peak of 55% to 60% in 2013-2014 (prior to acquisitions in mining and generation), though it will remain the largest EBITDA component.

Standalone Rating: 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, plans to introduce capacity market and support for coal mining like the rescue plan for PGG.

DERIVATION SUMMARY

ENEA has lower share of regulated distribution than the two other 'BBB' rated Polish integrated utilities, TAURON Polska Energia S.A. (Tauron, BBB/Stable) and Energa, and lower cash flow visibility. This is reflected in Fitch's lower maximum leverage guideline within current ratings of 3x for ENEA and 3.5x for Tauron and Energa. The largest Polish utility PGE Polska Grupa Energetyczna S.A. (BBB+/Stable) benefits from high share of lignite in its generation fuel mix, which in the current pricing environment for wholesale power and CO_2 allowances provides a cost advantage over its Polish peers generating power mostly from hard coal.

All four Polish integrated utilities have limited rating headroom due to a projected increase in leverage in 2017-2019 driven by large capex.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Weighted average cost of capital in the distribution segment at 5.6% in 2017 rising to 6.0% in 2021
- 5% reduction in the return on the distribution's regulated asset base from 2018
- Volume-weighted wholesale power price falling to about PLN160 per megawatt-hour and coal prices to about PLN9 per gigajoule by 2019
- The new 1GW power block in Kozienice commencing operations from 2018
- Capex and acquisitions of around PLN12bn in 2017-2021, including Ostroleka C preparatory and initial construction phase; we expect most of capex for construction of Ostroleka C after 2021
- PLN110 million dividends in 2017; no dividends from 2018

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

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 from 2017. 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.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- 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;
- Substantial adverse change in ENEA's business profile, such as a material reduction in the share of regulated distribution in total EBITDA;
- Involvement in Ostroleka C project construction phase as a 50% partner, without secured cash flow support from the capacity market or in a scenario of large dividends paid to shareholders;
- 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-March 2017 ENEA had Fitch-calculated readily available cash of PLN1.2bn and committed financing of PLN2.5bn against short-term debt of PLN0.3bn and Fitch-projected negative free cash flow of PLN0.2bn for 2017.

Contact:

Principal Analyst
Artur Galbarczyk
Associate Director
+48 22 338 6291

Supervisory Analyst
Arkadiusz Wicik
Senior Director
+48 22 338 6286
Fitch Polska S.A.
Krolewska 16
00-103 Warsaw

Committee Chairperson
Josef Pospisil
Managing Director
+44 20 3530 1287

Summary of Financial Statement Adjustments - Operating lease capitalised using a 7x multiple.

Media Relations: Adrian Simpson, London, Tel: 203 530, Email: adrian.simpson@fitchratings.com; Malgorzata Socharska, Warsaw, Tel: +48 22 338 62 81, Email: malgorzata.socharska@fitchratings.com.

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. 10 Mar 2017) (https://www.fitchratings.com/site/re/895493)
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016) (https://www.fitchratings.com/site/re/886557)

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