FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Energa to 'BBB-'; off RWN; Stable Outlook

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Fitch Ratings - Warsaw - 29 May 2020: Fitch Ratings has downgraded Poland-based Energa S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BBB-' from 'BBB'. The ratings have been removed from Rating Watch Negative (RWN) and the Outlook is Stable. A full list of rating actions is below.

The rating actions reflect our assessment of the strong links between Energa and its new parent PKN ORLEN S.A. (BBB-/Stable), following a successful tender offer for Energa's shares, under Fitch's Parent and Subsidiary Linkage (PSL) Rating Criteria. As a result, Energa's ratings are constrained by those of the consolidated credit profile of PKN ORLEN.

Energa's standalone credit profile (SCP) remains at 'bbb' and is supported by a solid business profile, moderate historical leverage and the likely abandonment of the Ostroleka C project in a coal-fired formula.

KEY RATING DRIVERS

Ratings at PKN ORLEN Level: PKN ORLEN's tender offer for Energa's shares was successfully completed in April 2020 on acquisition of 80% of capital and 85% of voting rights. The large majority achieved by PKN ORLEN implies strong links between the companies, which will lead to unification of strategies, gradual integration of operations and consolidation of Energa's results and debt by PKN ORLEN. Consequently, Energa's ratings are constrained by those of the new parent.

Tender Offer Rationale: The rationale for the Energa acquisition includes expansion of PKN ORLEN's energy business, addition of stable EBITDA from electricity distribution, and a renewables portfolio together with capabilities in renewables development and electric-vehicle infrastructure. Some further opportunities include optimisation of the energy portfolio and cross-selling of products and services. The tender offer was conditional on, among others, consent from the European Commission and the response rate of at least 66% of voting rights in Energa's shareholders meeting, which have been achieved.

Distribution Supports Credit Profile: The SCP of Energa continues to reflect its focus on regulated distribution activity, its main business segment, which is characterised by lower business risk and greater cash-flow predictability than conventional power generation. Energa has a high EBITDA contribution from regulated electricity distribution (81% in 2019). We expect the share of regulated EBITDA to average 75% in 2020-2024, contributing to cash-flow visibility.

Old Ostroleka C Suspended: Energa, together with ENEA S.A. (BBB/Stable), suspended construction of the 1GW coal-fired power block Ostroleka C in February 2020 and decided to reconsider its fundamentals, including a potential switch of fuel to gas from coal. However, PKN ORLEN recently declared its preliminary readiness for a direct financial involvement in the Ostroleka C project only if the fuel is changed to gas from coal. We believe that this effectively means abandonment of the Ostroleka C project in the old, coal-fired formula, given that Energa and ENEA have been unable to find other investors for a coal-fired power block. The formal decisions are still to be taken.

New Ostroleka C Unclear: Change of fuel to gas from coal will significantly delay the project due to the necessity to build a pipeline delivering gas to Ostroleka C, restarting the project with a new EPC contractor selection process and potentially covering justified costs to the selected contractor for the coal-fired block. The SPV will need to withdraw from the 15-year capacity payments contract it has won with delivery from 2023, potentially paying some compensations. Although the new Ostroleka C project is currently only conceptual, it should be more profitable due to the switch to gas and has a chance to attract external investors and adopt a project-finance formula, unlike the old coal-fired project.

Support from Capacity Market: Capacity payment for the Ostroleka C project will be severely delayed and depend on the decision regarding project implementation. However, Energa will still receive close to PLN200 million a year over 2021-2025 from capacity payments won by its other generation units, in particular Ostroleka B. Capacity payments are a quasi-regulated source of income, more reliable than selling electricity to the wholesale market. We project it will contribute around 10% to Energa's EBITDA and stabilise cash flows.

Negative Impact of Coronavirus: The coronavirus pandemic has lowered electricity demand in Poland in 2020, with a likely rebound from 2021. We expect Energa's all three business units will be hit, with supply being the hardest. Distribution will also be impacted as it does not benefit from an automatic volume-correction mechanism. We estimate that funds from operations (FFO) net leverage will peak at 4x in 2020, due to lower EBITDA on coronavirus impact, before decreasing to 3.5x over 2021-2023. Lower EBITDA in 2020 may also lead to a breach of Energa's net-debt-to-EBITDA (as per the company's definition) covenant of up to 3.5x. We expect Energa to either renegotiate the financing agreements or request a waiver.

DERIVATION SUMMARY

Energa's close peer group includes the three other electricity-focused integrated utilities in Poland, which are PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and TAURON Polska Energia S.A. (Tauron; BBB-/Stable). Across central Europe a close peer is CEZ, a.s. (A-/Stable). All peers are rated on a standalone basis.

Energa's and Tauron's business profiles benefit from a large share of regulated distribution in EBITDA, which provides good cash-flow visibility when conventional generation and mining are under pressure.

PGE is the largest company among Polish peers and has the lowest leverage among the peer group. It derives most of its EBITDA from electricity generation and has a high share of lignite in the generation fuel mix, which provides the company with some cost advantage over hard coal-fired peers such as ENEA and Tauron. Rising

CO_2 prices could diminish this cost advantage if not accompanied by high hard- coal prices, given the higher carbon footprint of lignite than hard coal.

ENEA has a lower share of regulated distribution than Energa and Tauron and at the same time higher exposure to hard coal-fired generation, but controls a low-cost mining business. The maximum leverage sensitivity for ENEA's 'BBB' rating is 3.0x.

CEZ' higher rating mainly reflects a low-cost generation fleet, a lower carbon footprint and lower leverage.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Weighted-average cost of capital in the distribution segment at 5.5% in 2020 and 4.7% average in 2021-2024

- Ostroleka C switches to gas-fired and is built in a project-finance formula

- Capex and acquisitions at PLN8.8 billion in 2020-2024; this includes Fitch-assumed PLN1 billion for construction of Ostroleka C, but any cash inflows from its operations are excluded

- Lower results in 2020 due to the pandemic, before rebounding from 2021

- Continuation of a no-dividend policy

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Positive rating action on or upgrade of PKN ORLEN's ratings

- Weaker links with the parent accompanied by a stronger SCP than the parent

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Negative rating action on or downgrade of PKN ORLEN's ratings

- Problems in getting a waiver in case of a covenant breach

- FFO net leverage above 3.5x or FFO interest cover below 6x on a sustained basis, for example, due to prolonged economic downturn, higher capex or reinstatement of dividends, would be negative for the SCP

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-2019 Energa had PLN1.4 billion of unrestricted cash and equivalents and PLN2.8 billion of undrawn committed credit lines against debt maturities of PLN2.5 billion in 2020 and PLN0.4 billion in 2021. Fitch-calculated free cash flow after acquisitions is a negative PLN1.5 billion in 2020 and positive at PLN0.3 billion in 2021.

The main debt maturity in 2020 was the EUR500 million Eurobond, which was repaid in March mostly from a PLN2 billion consortium loan. As per Fitch rating case Energa has sufficient liquidity until end-2021.

SUMMARY OF FINANCIAL ADJUSTMENTS

Equity credit of 50% allocated to hybrid bonds, and debt value adjusted for hedging.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Energa is credit-linked to PKN ORLEN.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Energa S.A.	LT IDR	BBB-	Downgrade
	LC LT IDR	BBB-	Downgrade
	Natl LT	A(pol)	Downgrade
• senior unsecured	LT	BBB-	Downgrade
• subordinated	LT	BB	Downgrade

ENTITY/DEBT **RATING**

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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