

Fitch Ratings

Fitch Affirms Poland's Energa at 'BBB'; Outlook Stable

Fitch Ratings-Warsaw/London-27 November 2015: Fitch Ratings has affirmed Poland-based Energa S.A.'s Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'BBB' with a Stable Outlook. A full list of rating actions is at the end of this rating action commentary.

The affirmation reflects the dominant share of the regulated electricity distribution business in Energa's EBITDA, which results in low business risk and good cash flow predictability. However, the recent decision of the regulatory office to substantially lower the weighted average cost of capital (WACC) in electricity distribution for 2016 has reduced the segment's profitability and Energa's rating headroom. The company's financial leverage is low, with funds from operations (FFO) adjusted net leverage of 1.5x in 2014. We project this ratio to increase to close to 3.5x by 2019, assuming implementation of a full capex plan, and which we see as the maximum leverage commensurate with the ratings.

KEY RATING DRIVERS

Distribution Supports Credit Profile

The ratings reflect Energa's focus on distribution activity, its main business segment, characterised by lower business risk and greater cash flow predictability than conventional power generation. Energa has a high EBITDA contribution from regulated electricity distribution (78% of EBITDA in 9M15). We expect the share of regulated earnings to remain around 75% in 2016-2017, contributing to cash flow visibility.

Energa has the highest share of regulated EBITDA among the four Fitch-rated Polish utilities (PGE Polska Grupa Energetyczna S.A. (BBB+/Stable), TAURON Polska Energia S.A. (BBB/Negative) and ENEA S.A. (BBB/Stable)). Unlike its Polish peers, Energa does not have plans for ongoing coal-fired power plant projects and has not expressed interest in acquiring coal mining assets. This reduces business risk given weak market conditions for conventional power generation, and the financial and liquidity problems of many domestic coal mining companies.

Energa's distribution and supply has a market share of 17% and 13% in Poland, respectively, compared with 3% in generation. Energa also lacks a mining business and has weaker conventional generation assets than its Polish peers.

Lowered Remuneration in Distribution

We project that the lower WACC for 2016 will reduce Energa's EBITDA from the regulated distribution business by about PLN130m in 2016 (or 6% of total EBITDA). The regulator has recently reduced WACC for 2016 to 5.68% (initially the proposal was even lower at 5.28%) from 7.2% for 2015 (or from 6.84% when incorporating a 5% haircut applied by the regulator). The WACC reduction is mostly due to a decrease in market interest rates. We assume that WACC will gradually increase to 6% in 2019.

From 2018, the regulatory return for distributors could be negatively affected by newly introduced 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.

Some Weaknesses in Regulatory Framework

Fitch views the regulatory framework for Polish distribution networks as supportive and stable. However, despite improvement since 2010, it still has several weaknesses compared with regulatory frameworks in some western European countries. These include the lack of a multi-year tariff-setting mechanism. There is also volume risk within the framework; for example, lower than expected distribution volumes reduce this segment's EBITDA.

An additional negative factor, which eroded Energa's cash flows in 2013-2015, is the legal obligation of Energa's electricity trading subsidiary, acting as a supplier of last resort, to purchase electricity from renewable energy sources (RES) located in Energa's area of operation. The purchase price is set by the regulator based on the average wholesale electricity price in the market in the previous year. This price mechanism means that if spot electricity prices are lower than in the previous year, as in 2015, Energa would incur a loss in its supply business given that it has to purchase electricity from RES at last year's prices and then sell it on the market at current lower prices.

Energa's exposure to this unfavourable regulation is higher than its Polish peers' given that a substantial part of the country's RES is located in Energa's area of operations in northern Poland. We expect the negative impact of this

regulation to moderately diminish in 2016 as the new act on renewables will change the price setting for this obligation to a quarterly basis from an annual basis, leading to smaller differences between the regulated and market electricity price.

No Uplift for Senior Unsecured Rating

The regulatory constraints have meant that Energa's senior unsecured rating does not benefit from a single-notch uplift over the Long-term IDR, which we typically apply to network utilities in developed markets. This is despite Energa's proportion of regulated cash flow being well above 50% of EBITDA.

Some of the regulatory constraints have been addressed by the energy regulatory office in the past few years, including the gradually increasing return on the regulatory asset base (RAB) since 2010, achievement of a full return on RAB in 2014, and gradual elimination of the gap between operating costs and costs approved by the regulator, leading to stronger cost recovery in tariffs.

Improvements in the regulatory framework, for instance implementation of multi-year tariffs or better visibility of WACC evolution in the medium term, contributing to stronger recovery expectations in case of default, may lead us to incorporate a one-notch senior unsecured uplift over the Long-term IDR for Energa and as a result to upgrade the senior unsecured rating of Energa and notes issued by its finance subsidiary Energa Finance AB (publ).

Reassessment of Leverage Guidelines

We view the increased proportion of cash flow contribution from regulated distribution in the past few years at the expense of generation as reducing Energa's business risk. We view regulated distribution as a lower risk business than generation, allowing for higher debt capacity. As a result of the increased importance of the distribution segment we have widened the negative rating guidance for the 'BBB' rating to 3.5x from 3.0x.

Credit Metrics to Deteriorate

We expect the company's capex to increase financial leverage from its current low level (FFO adjusted net leverage of 1.5x in 2014). Increased leverage will depend on the implementation of the capex programme, which contains some optional projects. The company is currently working on an update of the company's strategy and the long-term capex plan.

The latest announced capex plan for 2014-2022, was PLN18.2bn, of which PLN11.8bn was allocated to core projects, mainly in distribution (PLN9.8bn). The additional optional projects totalling PLN6.4bn include investments in renewables, acquisitions and R&D projects. These projects are subject to market conditions and the future support mechanism for renewables, as the existing system of green certificates will be replaced by an auction system from 2016. According to our projections, a full capex plan based on the existing strategy would result in an increase of Energa's net leverage to close to 3.5x by 2019, which is approaching the negative rating guideline.

A lower capex plan (in case some optional projects are not realised) would result in the company's net leverage increasing to less than 3x by 2017. We believe that Energa can easily cut back voluntary capex, such as wind farms, if market conditions deteriorate or if a new support system for renewables does not allow for sufficient profitability.

Potential Acquisitions of Mines

A risk for Polish utilities' ratings, including that of Energa, is domestic coal mining, which is in a difficult financial and liquidity position due to very low coal prices, high employment and cost base, and overcapacity. The previous government's support plan for mines included prepayments for coal by utilities and also the acquisition of some loss-making coal mines by state-controlled utilities. A broader consolidation of the power and coal mining sectors to support the mines was discussed but not implemented.

The elections on 25 October 2015 were won by the main opposition party. Consequently, a new government has been created, which may lead to changes in the state's strategy towards the electricity and coal mining sectors. In our view, the consolidation of utility and coal mining sectors would be ratings negative for utilities.

Rated on Standalone Basis

Energa is 51.52%-owned by the Polish state (A-/Stable), but Fitch rates it on a standalone basis because we assess legal, operational and strategic links with the state as moderate based on our Parent and Subsidiary Rating Linkage criteria. Following the changes to the company's articles of association (introduction of a 10% voting cap and voting privilege for some of the state's shares) implemented before its IPO in 4Q13, Energa will remain controlled by the government as long as its share in Energa is above 20%.

KEY ASSUMPTIONS

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

- Lower WACC in the distribution segment from 2016: 5.68% in 2016 and then gradually increasing to 6% in 2019
- Capex of PLN12bn in 2015-2019

- Opex savings of PLN150m by 2020
- Dividends of PLN500-600m per year

RATING SENSITIVITIES

Future developments that may, individually or collectively, lead to positive rating action include:

- Continued focus on the distribution business in capex and overall strategy, together with FFO adjusted net leverage below 2.5x on a sustained basis.
- Improvements in the regulatory framework, together with distribution networks remaining a dominant earning stream for Energa, which may lead to an upgrade of Energa's and Energa Finance AB (publ)'s senior unsecured rating in a one-notch uplift over the Long-term IDR.

Future developments that may, individually or collectively, lead to negative rating action include:

- Increase in FFO adjusted net leverage to above 3.5x on a sustained basis - for example, due to full implementation of capex and weaker than expected operating cash flow.
- Acquisitions of stakes in coal mines or other form of support for state-owned mining companies under financial pressure leading to net leverage above 3.5x or substantially worsening Energa's business profile.

LIQUIDITY

At end-September 2015, the company had Fitch-calculated readily available cash and cash equivalents of PLN2bn against short-term debt of PLN0.3bn. The first large debt repayment is not due until 2019 when PLN1.3bn of debt matures.

Energa's committed financing at end-September 2015 amounted to PLN1.0bn and was provided mostly in form of credit facilities and loans from commercial banks with further PLN0.9bn from EIB and EBRD being in the process of prolongation due to expiration.

In Fitch's view, Energa's readily available cash and committed financing are sufficient to cover negative free cash flow in 2015 and 2016 in a full capex scenario.

FULL LIST OF RATING ACTIONS

Energa S.A.

Long-term foreign currency IDR affirmed at 'BBB'; Stable Outlook

Long-term local currency IDR affirmed at 'BBB'; Stable Outlook

National Long-term rating affirmed at 'A(pol)'; Stable Outlook

Foreign currency senior unsecured rating affirmed at 'BBB'

Local currency senior unsecured rating affirmed at 'BBB'

National senior unsecured rating affirmed at 'A(pol)'

Energa Finance AB (publ), guaranteed by Energa S.A.

Foreign currency senior unsecured rating affirmed at 'BBB'

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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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