Research Update:

# Czech Energy Company CEZ 'A-' Ratings Affirmed On The Announced Acquisition Of A Majority Stake In CGNI; Outlook Stable

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## Rating Action Overview

- On March 21, 2024, integrated Czech utility CEZ a.s. announced that it had agreed to purchase a 55.2% stake in Czech Gas Networks Investments S.a.r.l. (CGNI), the largest gas distribution system operator (DSO) in the Czech Republic, for about €850 million. CEZ will finance the acquisition wholly with debt, representing about 8% of its S&P Global Ratings-adjusted debt in 2023.
- The integration of CGNI's fully regulated gas network activities will slightly benefit CEZ's competitive position, as it will increase the share of regulated earnings. We have therefore decreased the funds from operations (FFO)-to-debt requirement for the rating to about 20% from 25% previously. We expect the share of regulated earnings to rise to around 30% of EBITDA in the next two years.
- We therefore affirmed our 'A-' long-term issuer credit and issue ratings on CEZ.
- The stable outlook indicates our view that although CEZ should post strong credit metrics from 2024-2025 thanks to the acquisition and strong power prices, we expect its FFO to debt to soften and remain between 20% and 23% thereafter.

## Rating Action Rationale

**We affirmed our ratings on CEZ following its agreement to acquire a 55.21% stake in CGNI from Macquaire Asset Management for €850 million.** CGNI, through its subsidiary GasNet, is the largest gas distribution company in the Czech Republic, covering about 80% of the Czech market and servicing 2.3 million off-take points. About 10% of CGNI's EBITDA comes from its other subsidiary, GasNet Sluzby (Grid Services). The majority of this 10% derives from services that Grid Services provides to GasNet and only a very minor part derives from gas-related services that Grid Services provides to other DSOs. We expect CGNI's fully regulated gas network activities to comprise about 10% of CEZ's total EBITDA.

We expect the acquisition to close by the third quarter of 2024 and CEZ to fund it entirely with debt. We understand that CEZ intends to sign a one-year bridge loan with two six-month extension options underwritten by a syndicate of commercial banks. We also understand that CEZ plans to refinance this loan in the bond market later this year.

From 2024, we fully consolidate CGNI's €410 million-€420 million of reported EBITDA, €215 million of capital expenditure (capex), €2.9 billion-€3.0 billion of reported debt into CEZ's financials. Reported debt includes shareholder loans amounting to €580 million-€600 million that we treat as equity. The €2.9 billion-€3.0 billion of reported debt will remain at the CGNI level, meaning that CEZ has no plans to refinance it at its level.

**The acquisition is positive for CEZ's competitive position, considering CGNI's low-risk regulated activities.** The improvement of CEZ's competitive position reflects an increased share of regulated earnings. Following the acquisition, we estimate that about one-third of CEZ's EBITDA will derive from regulated assets and around two-thirds from unregulated power generation assets in the next two years. This compares with around 14% in 2023 and around 25% in 2024 based on our current power price assumption of €98 per megawatt hour (/MWh) in 2024. CEZ's business mix remains sensitive to movements in power prices.

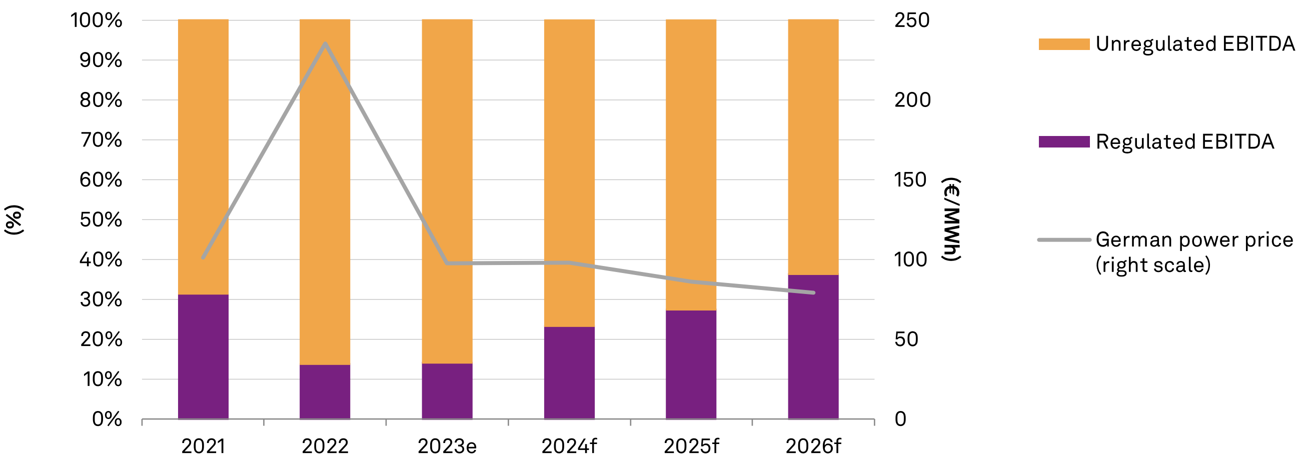
That said, we forecast that power prices will gradually decline to around €86/MWh after 2025, and this will have a positive effect on the regulated portion of EBITDA. To reflect CEZ's higher share of regulated earnings, we have decreased the FFO-to-debt requirement for the 'A-' rating to about 20% from about 25% previously. We will now benchmark CEZ's credit metrics against the medial volatility table.

We estimate that the acquisition will give CEZ €415 million–€450 million of additional EBITDA annually. Additionally, the acquisition of CGNI will make CEZ the leading gas and electricity DSO in the Czech Republic, and we view this as credit positive. We assess the Czech regulatory framework for gas DSOs as very supportive, based on our analysis of regulatory stability, tariff setting, financial stability, and regulatory independence and insulation. This is in line with our assessment of the Czech regulatory framework for electricity DSOs, which covers all CEZ's regulated operations before the acquisition. CEZ aims to leverage its extensive experience in power distribution and to focus on achieving synergies in operating both the gas and electricity networks in almost fully overlapping territories.

We expect slightly less than 70% of CEZ's EBITDA to stem from unregulated activities in future, based on our current power price assumptions, predominantly from power generation (see chart 1). CEZ will remain significantly exposed to the volatile power markets. Furthermore, the company still generates over one-third of its electricity from fossil fuels, notably lignite. We view this unfavorably compared to CEZ's rated peers like EnBW AG or SSE.

Chart 1

## Share of regulated and unregulated EBITDA versus power prices




MWh--Megawatt hour. e--Estimate. f--Forecast. Source: S&P Global Ratings



**We forecast that FFO to debt will remain in the 20%-23% range after 2025, down from around 25% in 2024.** CEZ posted strong results in 2023, with adjusted EBITDA reaching around Czech koruna (CZK) 128 billion (about €5.4 billion), slightly down from CZK135 billion in 2022. With the gradual normalization of power prices, we forecast that EBITDA will follow the same trend over 2024-2026, declining to around CZK130 billion in 2024 and then to about CZK120 billion in 2025. Furthermore, the Czech government's measures to tax generation revenue above the price caps and impose windfall taxes, which remain in place until 2025, will continue to affect CEZ's profitability.

At the same time, we forecast that CEZ's net debt will gradually increase year on year, as investments increases. Following the acquisition, we forecast that net debt will increase to around CZK320 billion-CZK330 billion in 2024 and then remain around CZK360 billion-CZK390 billion over 2025-2026. We forecast that capex will ramp up to around CZK60 billion in 2024 and CZK80 billion-CZK95 billion in 2025-2026, from around CZK46 billion in 2023, in line with its VISION 2030 strategic plan. CZK will direct most of this capex toward renewables and its regulated distribution networks.

At the same time, our base case assumes that, in line with its financial policy, CEZ will continue to pay dividends of 60%-80% of the year's adjusted profit after tax, with the exception of 2023. We expect dividends of about CZK22 billion-CZK26 billion in 2024-2025. Consequently, we expect FFO to debt to sit within the range of 20%-23%, which is above the 20% threshold for the 'bbb' stand-alone credit profile (SACP).

**Potential extraordinary support from the Czech government continues to support the rating.** In our view, CEZ benefits from such support thanks to its importance in implementing the government's policies and its strong link to the government. This currently provides two notches of uplift to CEZ's 'bbb' SACP. We expect that the Czech government will continue to own about 70% of CEZ. Our view further reflects CEZ's position as the dominant power generator and power distributor in the Czech Republic.

## Outlook

The stable outlook indicates our view that although CEZ should post strong credit metrics over 2024-2025 thanks to the acquisition and strong power prices, we expect its FFO to debt to soften and remain between 19% and 23% thereafter. We consider FFO to debt of about 20% to be commensurate with CEZ's 'bbb' SACP following the acquisition. In the medium term, we expect more than one-third of CEZ's EBITDA to come from regulated grids. We have not changed our view that there is a moderately high likelihood that the government of the Czech Republic would offer CEZ extraordinary support in case of need. This provides two notches of uplift to the SACP.

### Downside scenario

We could lower the ratings on CEZ if we revised its SACP downward by one notch or more. This could stem from:

- FFO to debt falling below 20% without a clear path to recovery. This could be a result of unplanned outages causing a fall in generated output, or power prices decreasing significantly beyond our base case;
- The regulated grid business' contribution falling below one-third of total EBITDA for an extended period; and
- Increased political risk depressing CEZ's financial metrics, and leading, for example, to a largely negative ratio of discretionary cash flow (DCF) to debt. This could occur if the government of the Czech Republic extracts more cash from power utilities than we anticipate in our base case, by increasing dividends or imposing windfall taxes.

### Upside scenario

We see limited upside potential for the ratings. An upgrade would require either a substantial, two-notch, upward revision of CEZ's SACP, a higher assessment of the likelihood of extraordinary government support, or an upgrade of the Czech Republic. That said, we could raise the SACP by one notch if CEZ's FFO to debt remains sustainably above 25% and its DCF to debt is less negative, alongside a supportive financial policy. A one-notch upward revision of the SACP would not trigger an upgrade, all else being equal.

## Company Description

CEZ is an integrated energy company present in a wide range of electricity-related businesses, namely, generation, distribution, supply, mining, and energy trading. CEZ is one of the leading economic entities in the Czech Republic. Furthermore, it operates in Germany, Poland, and Slovakia, as well as in France and Italy.

CEZ benefits from an unrivalled position in the Czech electricity market, with an approximate market share of 60% for its generation segment and 65% for its distribution segment. In 2023, it reported EBITDA of CZK124.8 billion. CEZ's largest shareholder is the Czech Republic, which has a 70% stake in the share capital and voting rights. The remaining 30% is publicly listed. As of Dec. 31, 2022, CEZ's market capitalization was CZK413 billion.

## Our Base-Case Scenario

Under our 2024-2026 base-case scenario, we assume:

- Real GDP growth in the Czech Republic of 2.0% in 2024, 2.5% in 2025, and 2.3% in 2026.
- The acquisition of 55.21% of CGNI for around €847 million, fully financed with debt.
- No significant changes to the regulatory framework for distribution companies, although the current regulatory period will end in 2025.

### Generation

- In 2024, total electricity supply from production in the Czech Republic of 41-42 terawatt hours (TWh).
- Hedging of 94% of prices in 2024 (€129/MWh), 65% in 2025 (€125/MWh), 29% in 2026 (€107/MWh), and 7% in 2027 (€92/MWh).
- S&P Global Ratings' power price assumptions for Germany (Czech power prices remain linked to those in Germany, with price differences of €1-€3/MWh from 2025): €98.1/MWh in 2024, €86.1/MWh in 2025, €79.2/MWh in 2026, €74.4/MWh in 2027, and €66.8/MWh in 2028 for the unhedged volumes.
- Carbon dioxide ($CO_2$) costs averaging around €79 per tonne for 2024, €82 per tonne for 2025, and €84 per tonne for 2026.
- An open position amounting to 17%–23% of electricity delivery from generation in the Czech Republic.

### Networks

- A pre-tax weighted-average cost of capital fixed at 6.54% for electricity distribution and 6.43% for gas distribution for the whole regulatory period until 2025.
- Our expectation that investments in the Czech distribution network will rise and remain at an increased level of about CZK18 billion. This compares with CZK8 billion in 2016, CZK11 billion in 2019, and CZK15 billion in 2022.
- A higher regulatory asset base, depreciation, and amortization affecting EBITDA.

### Sales and energy service companies

- EBITDA from electricity and gas sales of around 5% of total consolidated EBITDA for 2024-2026.

### Mining

- A fall in the amount of EBITDA from mining over 2024-2026, following a substantial increase to around 10% of total EBITDA in 2023, thanks to higher coal sales at higher realized prices.

## Other and financial policy

- Adjusted EBITDA of CZK125 billion-CZK130 billion in 2024, declining to about CZK100 billion-CZK105 billion in 2026 and 2027 due to normalized power prices. Of the total adjusted EBITDA, CGNI contributes around CZK10 billion-CZK11 billion on average in 2024-2026.
- EBITDA margins of about 30%-34%.
- An increase in capex to around CZK60 billion-CZK65 billion in 2024, then CZK80 billion-CZK85 billion in 2025 and CZK90 billion-CZK95 billion in 2026, driven by investments in new solar and gas capacity in the Czech Republic.
- A dividend payout of around 70% for 2024-2026, in line with CEZ's dividend policy.
- Average cash taxes of around CZK28 billion-CZK30 billion for 2024-2026.
- An average interest expense of around CZK10 billion-CZK11 billion for 2024-2026, a substantial increase from around CZK6 billion in 2023 due to new debt financing for the CGNI acquisition.
- The acquisition of CGNI for €845 million in the third quarter of 2024, but no other large debt-financed acquisitions.

## Key metrics

### CEZ a.s.--Forecast summary

| Industry sector: Energy | | | | | |
|---|---|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | | | |
| (Bil. CZK) | 2021a | 2022a | 2023e | 2024f | 2025f |
| EBITDA | 51.8 | 135.3 | ~128 | 125-135 | 120-130 |
| Funds from operations (FFO) | 43.5 | 125.4 | ~137 | 78-83 | 75-80 |
| Debt | 188.3 | 257.2 | ~260 | 320-330 | 355-365 |
| Debt/EBITDA (x) | 3.6 | 1.9 | ~2.0 | 2.4-2.6 | 2.7-3.0 |
| FFO/debt (%) | 23.1 | 48.8 | ~24 | 23-26 | 20-23 |

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. CZK--Czech koruna.

## Liquidity

We view CEZ's liquidity position as adequate under our criteria, based on our expectation that available liquidity resources will cover cash outflows by more than 1.2x in the next 12 months. Supportive qualitative factors include strong bank support, the company's high standing in the credit markets, and the ongoing benefits of its state ownership. We understand that management has arranged a two-year bridge loan to fully finance the acquisition, and we expect it to refinance this loan well in advance of its maturity.

### Principal liquidity sources

We expect the liquidity sources over the 12 months from Dec. 31, 2023, to be:

- Unrestricted cash and liquid securities of CZK17.6 billion;
- Availability of about CZK61.3 billion under various committed back-up facilities maturing after 12 months. This is split across approximately 25 facilities and 14 institutions;
- Cash FFO of about CZK79 billion; and
- A euro-denominated bridge loan to finance the acquisition of CGNI of around CZK21 billion (about €850 million).

### Principal liquidity uses

We expect that principal liquidity uses over the same period will include:

- Debt maturities of about CZK37.8 billion;
- Annual capex of about CZK62 billion;
- A dividend of about CZK26 billion; and
- Acquisition spending on CGNI of about CZK21 billion.

## Environmental, Social, And Governance

We assess CEZ's management and governance score as neutral. Over the past decade, CEZ has committed to generating carbon-neutral electricity by 2040 and has implemented several measures to reduce its $CO_2$ emissions intensity by upgrading its lignite fleet and planning to close some of its least efficient lignite and hard coal plants. CEZ emitted 0.27 metric tonnes of $CO_2$/MWh in 2023 versus 0.57 in 2010.

We think that CEZ remains significantly exposed to challenges arising from carbon price developments and EU decarbonization objectives in light of its carbon-intensive fleet. This fleet will require substantial investment to generate carbon-neutral electricity. Electricity generation from coal was approximately 30% of CEZ's total output, or 15.4 TWh, in 2023. Additional risks lie in CEZ's sizable nuclear fleet (59% of output in 2023).

In 2015 and 2016, CEZ mismanaged the surveillance of its reactors, causing significant outages and additional costs. Its end-of-cycle liabilities for both decommissioning and nuclear waste storage are also significant. We capture these in our debt adjustment for asset retirement obligations (approximately CZK66 billion in 2020).

From a social perspective, the Czech Republic's main political parties support both nuclear and coal, acknowledging nuclear generation's central role in preserving national energy independence. In recent years, renewable energy ambitions have increased, and the country's climate and energy plan envisages a significant increase in the share of production it targets from renewables to 22% in 2030 from 13.0% in 2020, or approximately 1 gigawatt of solar capacity.

We expect that CEZ will be a significant operator in the Czech Republic, but that it will require significant investments. CEZ's nuclear activities also pose several governance risks, as we believe that the uncertainty surrounding the government's decision on future nuclear reactor construction will continue to limit the long-term visibility of the company's overall structure and strategic directions.

## Government Influence

We consider CEZ to be a government-related entity and believe that there is a moderately high likelihood that the Czech government would provide extraordinary support to CEZ in the event of financial distress. Our assessment is based on CEZ's important role for the Czech government, as a provider of an essential service, and its strong link with the Czech government, as the latter is involved in key strategic decisions through its representation on CEZ's supervisory board. The finance ministry owns about 70% of CEZ, and the remaining shares are publicly held.

## Issue Ratings--Subordination Risk Analysis

### Capital structure

CEZ's debt structure comprises senior unsecured debt in the form of bonds and loans issued at the parent level. All of the company's financial debt is at the CEZ level. Following the consolidation of CGNI in 2024, CEZ will have approximately CZK54 billion of debt on a subsidiary level, which we expect to raise the ratio of priority debt to 15%-20% of total debt. Since the priority debt ratio is below 50%, we do not consider CEZ's unsecured debt to be subordinated.

### Analytical conclusions

We rate debt the issued by CEZ 'A-', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

## Ratings Score Snapshot

| Issuer Credit Rating | A-/Stable/-- |
|---|---|
| Business risk: | Strong |
| Country risk | Intermediate |
| Industry risk | Intermediate |
| Competitive position | Strong |
| Financial risk: | Significant |
| Cash flow/leverage | Significant |
| Anchor | bbb |
| Modifiers: | |
| Diversification/Portfolio effect | Neutral |
| Capital structure | Neutral |
| Financial policy | Neutral |
| Liquidity | Adequate |
| Management and governance | Neutral |

| Issuer Credit Rating | A-/Stable/-- |
|---|---|
| Comparable rating analysis | Neutral |
| Stand-alone credit profile: | bbb |
| Related government rating | AA- |
| Likelihood of government support | Moderately high |

## Related Criteria

- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Research

- Industry Credit Outlook 2024: EMEA Utilities, Jan. 9, 2024
- Eastern Europe: Higher Yields Will Weaken Credit Metrics And Liquidity, Jan. 8, 2024
- Eastern European Utilities' Regulatory Frameworks Are Varied, But Most Are Adequate To Strong, Sept. 18, 2023
- Czech Gas Networks Investments S.a r.l., March 6, 2023

## Ratings List

| Ratings Affirmed | |
|---|---|
| **CEZ a.s.** | |
| Issuer Credit Rating | A-/Stable/-- |
| Senior Unsecured | A- |

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.