MOODY'S
INVESTORS SERVICE

Credit Opinion: CEZ, a.s.

Global Credit Research - 03 Apr 2014

Prague, Czech Republic

Ratings

Category	Moody's Rating
Outlook	Negative
Senior Unsecured	A2
CEZ MH B.V.	
Outlook	Negative
Bkd Senior Unsecured -Dom Curr	A2

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Key Indicators

CEZ, a.s.[1]

	12/31/2013	12/31/2012	12/31/2011	12/31/2010	12/31/2009
(CFO Pre-W/C + Interest) / Interest Expense	7.1x	8.1x	8.1x	10.8x	13.2x
(CFO Pre-W/C) / Net Debt	31.3%	34.3%	37.4%	45.7%	51.8%
RCF / Net Debt	20.1%	21.7%	23.0%	27.9%	34.5%
FCF / Net Debt	2.7%	-6.8%	-9.8%	-9.0%	-6.5%

[1] All ratios are calculated using Moody's standard accounting adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Leading position in the Czech power generation market, with strong exposure to low-cost nuclear and lignite power production

Power price weakness. Fixed-cost nature of CEZ's generation fleet limits possibilities to offset falling revenues and operating cash flows. Measures to mitigate pressure on operating cash flows, such as reduction of capex and dividend payouts.

Development of new nuclear plants in the Czech Republic. The financing of new nuclear plants would result in considerable capex spending and weigh on financial metrics. It would also be uneconomical without state support.

Financial policy: An increase of the current target payout ratio of 50-60% would weigh on financial metrics.

Corporate Profile

CEZ a.s. (CEZ) is one of the largest electric utility companies in Central and Eastern Europe with approximately 15 gigawatts (GWs) of power generation capacity and 8.5 million customers. CEZ's core businesses are (i) power production and trading, which comprised 60% of group EBITDA in 2013; and (ii) distribution and supply, which contributed 27%. In addition, the company is involved in heat production and distribution, coal mining and other activities, which complement the core business segments and contributed around 13% to group EBITDA in 2013. CEZ is approximately 70% owned by the Government of the Czech Republic (A1, stable).

Rating Rationale

CEZ's A2 rating is underpinned by the company's leading position in the Czech electricity market, size and scale within Central & Eastern Europe and its majority ownership by the Government of the Czech Republic (A1, stable).

CEZ is the largest power generator in the Czech Republic. This strong position is further supported by its well-balanced vertical integration. However, CEZ's generation fleet is predominantly fixed-cost in nature. While this makes the company particularly exposed to changes in the overall power price, it is somewhat protected in the near-to-medium term via its forward-selling strategy.

While lower prices will likely lead to a reduction in operating cash flow from 2015 onwards, Moody's believes that CEZ has some capacity to absorb this through further cuts to expenditure, if required. However, its ability to manage this environment may be constrained by a new and more aggressive dividend policy.

CEZ's rating incorporates a 1 notch uplift to its standalone credit quality (expressed as a baseline credit assessment - BCA of a3) for potential government support to avoid a default if this were ever to be required.

DETAILED RATING CONSIDERATIONS

LOW-COST GENERATION FLEET SUFFERS FROM WEAK POWER PRICES

With around 15GW of installed capacity, CEZ is the largest generator in the Czech Republic - having a market share of around 70%. This strong position is further supported by its well-balanced vertical integration: (1) CEZ's own coal mines cover the majority of its lignite needs and (2) CEZ has a high market share in downstream distribution and supply. Offsetting this however, is the fact that CEZ's generation fleet in the Czech Republic is predominantly fixed-cost in nature - with around 80% of its capacity represented by lignite, nuclear and hydro. While this makes the company particularly exposed to changes in the overall power price, it is somewhat protected in the near-to-medium term via its forward-selling strategy with around 86% of its power pre-sold for 2014 and around 73% pre-sold for 2015 - at prices of EUR44.5/MWh and EUR40.8/MWh, respectively.

The development of power markets, however, suggests pressure on realized power prices and resulting profitability of the generation business in the upcoming years. Since January 2012, one year forward power prices in the Czech Republic have fallen from around EUR50/MWh to around EUR35/MWh in March 2014. This significant deterioration has been driven by a number of factors including: (1) falls in the price of coal and carbon, which have reduced the cost of generation of price-setting plants in the region, (2) significant additions of renewable based generation sources on to the grid; and (3) weak demand for electricity. However, since mid-2013 power prices in the region have stabilised reflecting: (1) a modest increase in the price of carbon to around EUR6/tonne reflecting in part a plan by the European Commission to reform the market and boost prices; and (2) an improving outlook for the European macro economy.

FALLING CAPEX COULD COMPENSATE EFFECTS FROM WEAK POWER PRICES, BUT DEVELOPMENT OF NEW NUCLEAR REPRESENTS A RISK

While lower prices will likely lead to a reduction in operating cash flow from 2015 onwards, Moody's believes that CEZ has some capacity to absorb this through further cuts to expenditure, if required. This is underpinned by CEZ's investment program, which includes a reduction in capex from ca. CZK45 billion in 2013 and 2014 to around CZK30 billion per annum between 2015 and 2018.

CEZ has been preparing the development of two new nuclear units, no. 3 and 4, at its existing site in Temelin (Czech Republic). Before taking a final investment decision, CEZ management expects a support mechanism by the state, to ensure an adequate return on investment in current times of low power prices. There is a number of possibilities, including (1) a contract for difference (CfD) scheme, similar to the one being considered in the UK and (2) the state taking care of financing of the project, for example via a special purpose vehicle (SPV).

The strategy to invest in new nuclear units could increase CEZ's capex levels materially. While we do not currently factor into CEZ's rating the additional risk associated with such investment, we do believe that the long lead time and high initial upfront cost associated with new nuclear could weigh on the financial profile of the group in the future. Moreover, even on a very long-term horizon, Moody's believes that investments in new nuclear generation units would be uneconomical unless (1) power prices increased considerably compared to current levels and / or (2) new nuclear plants would benefit from government support. Moody's believes that the risk of CEZ investing into the project without government support has become small. At the same time, however, there is a risk that the Czech state might act as an investor and refinance itself via CEZ, e.g. in form of higher dividend payouts.

BALANCED FINANCIAL POLICY, BUT CHANGES OF DIVIDEND POLICY WOULD BE CREDIT NEGATIVE

Given that around 30% of CEZ's shares are listed on the Prague stock exchange, the company needs to balance the interests of both stockholders and creditors. CEZ's historically solid financial performance enabled the company to gradually increase its dividend payouts, reaching its target payout ratio of 50%-60%, and execute a sizeable share buy-back. We believe that CEZ will review its dividend distribution policy as necessary, in order to maintain a stable financial profile.

However, on 24 March 2014 the new Finance Minister - Mr. Andrej Babis - suggested that CEZ should chase the dividend policy towards 100% payout of its net income for 2013. If the Annual General Meeting followed this suggestion, and such a policy were sustained the resulting increase in leverage would significantly, and negatively affect CEZ's financial profile.

OWNERSHIP OF CZECH STATE PROVIDES RATING UPLIFT

The strong support assigned to CEZ reflects its critical role within the Czech energy sector and its high strategic importance to the overall Czech economy, given that it represents one of the largest employers and contributors to the state budget. Any impact of a potential reduction in state ownership on our support assumption will depend on the government's rationale for disposing of its shares and the targeted final ownership. Our strong support assumption will not be affected by any reduction in state ownership, as long as CEZ remains at least 51% owned by the Czech Ministry of Finance and the owner supports the company's strategy.

Moderate default dependence reflects the fact that CEZ generates the majority of its earnings in the Czech Republic, notwithstanding its electricity export business and revenues from foreign acquisitions. In addition, CEZ is among the largest companies in the Czech Republic, as a result of which there is a significant correlation between the credit quality of the company and overall macroeconomic development in its domestic region.

Liquidity

While CEZ's liquidity on a 12 months forward looking basis is good, underpinned by robust cash flow generation and around CZK27 billion of undrawn committed facilities, the group's expected capex and dividend distribution will provide more of a funding challenge from 2014 onwards. Moody's expects that CEZ will spend around CZK 45 billion on capital expenditure in 2014 and around CZK 30 billion per annum over the near-to-medium term, the bulk of which is for the Czech generation business, particularly maintenance and the finalization of upgrades of certain lignite plants. Furthermore, investment in new nuclear units would likely further weaken the financial profile of the group. Additionally, CEZ company has around CZK 33 billion of debt maturing before the end of first half 2015 and will be reliant on access to the capital markets in order to execute this refinancing.

Rating Outlook

In May 2013, Moody's changed the outlook on the senior unsecured ratings of CEZ to negative from stable. Since 2011, forward power prices in the Czech Republic have decreased from around EUR55/MWh to around EUR35/MWh driven by a number of distinct factors including (1) falls in the price of thermal coal and carbon, which have reduced the cost of generation of the price-setting plants in the region (2) significant additions of renewable based generation sources onto the grid, which have a very low marginal cost and have displaced thermal plants in the merit order (3) weak demand for electricity given the performance of the overall European economy.

Given this significant deterioration in the power generation environment, Moody's expects that CEZ's key credit metrics could fall below its guidance for the current A2 rating (funds from operations (FFO) / net debt above 30%; and retained cash flow (RCF) / net debt above 20%) in 2014 and 2015 although metrics should improve again in 2016 and 2017, assuming the existing payout ratio (of 50-60%) is maintained.

While CEZ's strategy to invest in one or more nuclear units at its Temelin site would likely lead to a significant reduction in key credit metrics, to levels incommensurate with the existing rating, Moody's does not currently factor in this risk as there remains significant uncertainty regarding both the timing and support level for such a project.

What Could Change the Rating - Up

Given the negative outlook on the ratings, Moody's does not expect upwards rating pressure. Confirmation of the existing dividend policy would be a catalyst for Moody's to consider stabilising the outlook.

What Could Change the Rating - Down

Negative pressure on CEZ's rating would develop if (1) Moody's considers that recovery and maintenance of financial metrics at levels comfortably above guidance over the medium term is unlikely; (2) the group were to materially increase its payout policy; or (3) the group develops new nuclear units that further weakens its financial profile.

Rating Factors

CEZ, a.s.

Unregulated Utilities [1][2]	**Current View As at 12/31/2013**		[3]**Moody's 12-18 months Forward View As at 04/02/2014**	
Factor 1: Market Assessment, Scale & Competitive Position (25%)				
a) Size and Scale		A		A
b) Competitive Position and Market Structure		A		A
Factor 2: Cash Flow Predictability of Business Model (25%)				
a) Fuel Strategy and Mix		Baa		Baa
b) Degree of Integration and Hedging Strategy		A		A
c) Capital Requirements and Operational Performance		Ba		Ba
d) Contribution from Low/High Risk Businesses		A		A
Factor 3: Financial Policy (10%)				
a) Financial Policy		Baa		Baa
Factor 4: Financial Strength Metrics (40%)				
a) (CFO Pre-W/C + Interest) / Interest Expense (3 year Avg)	7.1x	A	6.0-7.0x	A
b) (CFO Pre-W/C) / Net Debt (3 year Avg)	31.3%	A	29-31%	A
c) RCF / Net Debt (3 year Avg)	20.1%	A	19-21%	A
d) FCF / Net Debt (3 year Avg)	2.7%	Baa	-2-0%	Ba
Rating:				
a) Indicated BCA from Grid factors 1-4		a3		a3
b) Actual BCA Assigned		a3		a3

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	a3
b) Government Local Currency Rating	A1
c) Default Dependence	Moderate
d) Support	Strong

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2013; Source: Moody's Financial Metrics [3] This is Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures