MOODY'S
INVESTORS SERVICE

Credit Opinion: CEZ, a.s.

Global Credit Research - 07 Apr 2016

Prague, Czech Republic

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Baa1
CEZ MH B.V.	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	Baa1

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Key Indicators

[1]**CEZ, a.s.**

	31/12/2015	31/12/2014	31/12/2013	31/12/2012	31/12/2011
(CFO Pre-W/C + Interest) / Interest	**8.1x**	**7.4x**	**7.3x**	**8.3x**	**8.1x**
(CFO Pre-W/C) / Net Debt	**33.3%**	**31.5%**	**31.9%**	**35.0%**	**37.4%**
RCF / Net Debt	**19.9%**	**19.6%**	**20.7%**	**22.4%**	**23.0%**
FCF / Net Debt	**12.2%**	**7.4%**	**2.7%**	**-6.8%**	**-9.8%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics.

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 large exposure to low-cost nuclear and lignite power production

- Regulated network distribution activities support cash flow stability

- Weaker ratios expected over the medium term as lower power prices feed through

- Long-term uncertainty surrounding development of new nuclear plants in the Czech Republic

Corporate Profile

CEZ, a.s. (CEZ, Baa1 stable) is one of the largest electric utility companies in Central and Eastern Europe with

15.9 gigawatts (GWs) of power generation capacity and more than 7 million customers. The group operates primarily in the Czech Republic (74% of revenues in 2015) as well as in Bulgaria (12%), Romania (6%) and Poland (3%). CEZ's core businesses are (1) power production and trading, which comprised 48% of group EBITDA in 2015; and (2) distribution and supply, which contributed 40%. In addition, the group is involved in coal mining and other activities, which complement the core business segments and contributed around 12% to group EBITDA in 2015.

CEZ is approximately 70% owned by the Government of the Czech Republic (A1 stable), whilst the remaining shares are listed on the Prague stock exchange. The company's current market capitalisation is around CZK220 billion (EUR8.3 billion).

Rating Rationale

CEZ's Baa1 rating is underpinned by (1) the company's leading position in the Czech electricity market and well-balanced vertical integration; (2) the low-cost nature of its nuclear and lignite generation fleet; and (3) the cash flow stability stemming from its regulated distribution activities. These factors are balanced by (1) a weak power price environment which weighs on the group's profitability given the fixed-cost nature of its generation fleet; and (2) the potential for additional material investments and new nuclear development. Current financial ratios are above the guidance for the Baa1 rating, with funds from operations (FFO)/net debt of 33% at year-end 2015, although we expect them to weaken in the coming years as hedges roll off and low power prices feed through. Finally, the Baa1 rating incorporates one notch of rating uplift given the Czech government's 70% ownership.

DETAILED RATING CONSIDERATIONS

LEADING POSITION AS ELECTRIC UTILITY IN CZECH REPUBLIC ALTHOUGH WEAK POWER PRICES AFFECT PROFITABILITY

With around 13GW of installed capacity, CEZ is the largest generator in the Czech Republic - having a market share of close to 70%. The company benefits from a low-cost generation fleet, with around 85% of its capacity represented by lignite, nuclear and hydro. This strong position is further supported by its vertical integration as (1) CEZ's own coal mines cover more than 70% of its lignite needs; and (2) it has a 37% market share in supply. Mitigating this however, is the fact that CEZ's generation fleet in the Czech Republic is predominantly fixed-cost in nature, which makes the company particularly exposed to changes in power prices.

In common with its peers, CEZ has been impacted by the weak power price environment in Europe. Czech power prices are closely linked to German power prices given the interconnections between the two countries. Current one-year forward wholesale prices around EUR22/MWh in Germany thus point to further pressure on the group's profitability, although it is partly protected in the near term by its forward-selling strategy with around 85% of its power pre-sold for 2016 and 67% pre-sold for 2017 at prices of EUR35/MWh and EUR31.5/MWh, respectively.

REGULATED DISTRIBUTION ACTIVITIES SUPPORT CASH FLOW STABILITY

In addition to domestic generation and supply, CEZ's rating is supported by its regulated electricity distribution activities in the Czech Republic whose revenues benefit from a relatively high degree of visibility. Czech distribution activities, which accounted for 24% of group EBITDA in 2015, are in their fourth regulatory period which covers the 2016-18 period. CEZ owns and operates 5 of the 8 distribution grids in the country representing an aggregate RAB of CZK85 billion and covering around 60% of total customers. Revenues are underpinned by a well-developed regulatory framework allowing for cost and investment recovery, with a current WACC (nominal, pre-tax) of 7.95%. The group's distribution activities in Romania and Bulgaria, albeit much smaller in scale, are in their third and fourth regulatory period, respectively.

WEAKER CREDIT METRICS EXPECTED OVER THE MEDIUM TERM AS LOW POWER PRICES AND POTENTIAL NEW INVESTMENTS FEED THROUGH

Lower power prices will lead to a further reduction in operating cash flow from 2016 onwards as hedges roll off, although the impact on credit metrics will be partly mitigated by a reduced capex program of around CZK30-35 billion per annum between 2016 and 2020 following the completion of investments designed to refurbish and upgrade the generation fleet (vs. in excess of CZK40 billion per annum before 2014). Based on market power prices around EUR22/MWh, we expect that CEZ will demonstrate FFO/net debt in the high twenties in percentage terms and retained cash flow (RCF) / net debt in the low twenties in percentage terms in the medium term in the absence of additional investments that have not been identified yet. These compare with actual ratios of FFO/net debt of 33% and RCF/net debt of 20% at year-end 2015.

This pressure on credit metrics could be further exacerbated by the company's intention to invest an additional CZK50 to 60 billion by 2020 into renewables, decentralized solutions, heat sector and distribution, notably, should the opportunities arise. Our guidance for the Baa1 rating, including FFO/net debt around the mid twenties in percentage terms and RCF/net debt in the high teens in percentage terms, factors in that CEZ has amended its leverage target, to 2.5x - 3.0x net debt / EBITDA from 2.0x - 2.5x previously, to accommodate such potential additional investments.

DEVELOPMENT OF NEW NUCLEAR WOULD BE CREDIT NEGATIVE

CEZ has been preparing the development of two new nuclear units, no. 3 and 4, at its existing site in Temelin in Czech Republic. This reflects the government's energy policy and willingness to maintain nuclear as a key component of the country's fuel mix in the future. We believe that the long lead time and high initial upfront costs associated with new nuclear would weigh on the financial profile of the group in the future, although we note that the structure of the investment and its responsibility are yet to be decided. CEZ's Baa1 rating does not currently factor in the risk of new nuclear investment as there remains significant uncertainty regarding both the timing and support level for such a project, as any investment in new nuclear will likely require state support given current low power prices.

OWNERSHIP BY CZECH STATE PROVIDES RATING UPLIFT

In accordance with our rating methodology for Government-Related Issuers (GRIs), CEZ's Baa1 rating incorporates one notch of uplift from its standalone credit quality or Baseline Credit Assessment (BCA) of baa1 based on our estimate of strong support from the government of Czech Republic (A1 stable). This reflects CEZ's 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. A potential reduction in state ownership is unlikely to impact our support estimate 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 balances (1) the fact that CEZ generates the majority of its earnings in the Czech Republic and is among the largest companies in the country, as a result of which there is a significant correlation between its credit quality and the overall macroeconomic development in the region; with (2) an exposure to developments in the German power market which influence heavily power prices in the Czech Republic.

Liquidity

CEZ's liquidity is strong, underpinned by CZK13 billion of cash, CZK12 billion of highly liquid financial assets and CZK30.5 billion of undrawn committed facilities at 31 December 2015. We believe that these sources, together with the proceeds from recent private placements and our expectation of EBITDA of CZK55-60 billion in 2016, should be sufficient to meet the company's liquidity needs in the coming 12 months. These include dividends of around CZK20 billion, capex of around CZK30-35 billion and debt maturities of CZK12 billion.

Rating Outlook

The outlook is stable, reflecting our expectation that CEZ's key credit metrics will remain aligned with the guidance for the current Baa1 rating, which includes FFO/net debt around the mid twenties in percentage terms and RCF/net debt in the high teens in percentage terms.

What Could Change the Rating - Up

Higher than expected power prices or a moderate dividend policy resulting in FFO/net debt sustainably in the high twenties to low thirties in percentage terms and RCF/net debt comfortably above 20% on a sustainable basis, could exert upward pressure on ratings.

What Could Change the Rating - Down

Negative pressure on CEZ's rating would develop if (1) financial ratios fall permanently below our guidance for the Baa1 rating; (2) the group undertakes a large debt-funded acquisition in addition to its announced potential investments; or (3) it starts developing new nuclear units that weaken its business and/or financial risk profile.

Rating Factors

CEZ, a.s.

Unregulated Utilities and Unregulated Power Companies Industry Grid [1]	Current as of 12/31/2015		[2]Moody's 12-18 Month Forward ViewAs of April 2016	
Factor 1 : Scale (10%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale (USD Billion)	24	A		A
Factor 2 : Business Profile (40%)				
a) Market Diversification		Ba		Ba
b) Hedging and Integration Impact on Cash Flow Predictability		Baa		Baa
c) Market Framework & Positioning		Ba		Ba
d) Capital Requirements and Operational Performance		A		A
e) Business Mix Impact on Cash Flow Predictability		Aa		Aa
Factor 3 : Financial Policy (10%)				
a) Financial Policy		Baa		Baa
Factor 4 : Leverage and Coverage (40%)				
a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg)	7.6x	Baa	6x-8x	Baa
b) (CFO Pre-W/C) / Net Debt (3 Year Avg)	32.2%	Baa	27%-32%	Baa
c) RCF / Net Debt (3 Year Avg)	20.1%	Baa	15%-20%	Baa
Rating:				
a) Indicated Rating from Grid		Baa2		Baa2
b) Baseline Credit Assessment (BCA)				baa2

Government-Related Issuer	Factor
a) Baseline Credit Assessment (BCA)	baa2
b) Government Local Currency Rating	A1
c) Default Dependence	Moderate
d) Support	Strong
e) Final Rating Outcome	Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics [2] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.