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Credit Opinion: CEZ, a.s.

Global Credit Research - 22 Apr 2015

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

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

	31/12/2014	31/12/2013	31/12/2012	31/12/2011	31/12/2010
(CFO Pre-W/C + Interest) / Interest	6.6x	7.1x	8.1x	8.1x	10.8x
(CFO Pre-W/C) / Net Debt	28.6%	31.3%	34.3%	37.4%	45.7%
RCF / Net Debt	16.6%	20.1%	21.7%	23.0%	27.9%
FCF / Net Debt	7.5%	2.7%	-6.8%	-9.8%	-9.0%

[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

- Weak power prices exert pressure on cash flows given fixed-cost nature of CEZ's generation fleet

- Regulated network distribution activities support cash flow stability

- Positive free cash flow generation expected to strengthen from 2016 once the large investment programme designed to refurbish power plants is completed

- Uncertainties surrounding dividend policy, M&A activity and development of new nuclear plants in the Czech Republic

Corporate Profile

CEZ a.s. (CEZ) is one of the largest electric utility companies in Central and Eastern Europe with approximately 16 gigawatts (GWs) of power generation capacity and 7.3 million customers. The group operates primarily in the Czech Republic (76% of revenues in 2014) as well as in Bulgaria (12%), Romania (6%) and Poland (2%). CEZ's core businesses are (1) power production and trading, which comprised 56% of group EBITDA in 2014; and (2) distribution and supply, which contributed 32%. In addition, the group is involved in heat production and distribution, coal mining and other activities, which complement the core business segments and contributed around 12% to group EBITDA in 2014.

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 CZK350 billion.

Rating Rationale

CEZ's A2 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; (2) the potential for large M&A activity and new nuclear development; and (3) a financial profile that remains weak for the current rating level with funds from operations (FFO) / net debt of 29% at year-end 2014, albeit with the potential for improvement as free cash flow generation is expected to strengthen from 2016 onwards once capex decreases. Finally, the A2 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 in excess of 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 well-balanced vertical integration as (1) CEZ's own coal mines cover close to three-quarters of its lignite needs; and (2) it has a 36% 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, which was the main driver behind the 12% drop in the group's 2014 EBITDA. Czech power prices are closely linked to German power prices given the interconnections between the two countries. Current one-year forward wholesale prices around EUR32/MWh in Germany thus point to further potential pressure on the group's profitability, although it is somewhat protected in the near to medium term by its forward-selling strategy with around 85% of its power pre-sold for 2015 and around 70% pre-sold for 2016 at prices of EUR39.5/MWh and EUR35.5/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 as well as in Bulgaria and Romania, whose revenues benefit from a relatively high degree of visibility. Czech distribution activities, which accounted for 22% of group EBITDA in 2014, are in their third regulatory period which will finish in 2015. CEZ owns and operates 5 of the 8 distribution grids in the country, thus covering close to two-thirds of total customers. Revenues are underpinned by a well-developed RAB-based regulatory framework allowing for cost and investment recovery, with a current WACC (nominal, pre-tax) of 6.1%. The group's distribution activities in Bulgaria and Romania, albeit much smaller in scale, are also in their third regulatory period - both ending in 2018.

CREDIT METRICS WEAKLY POSITIONED ALTHOUGH FREE CASH FLOW SHOULD STRENGHTEN FROM 2016 AS CAPEX DECREASES

The rating factors in the group's conservative financial policy, as reflected in a leverage target (expressed as net debt to EBITDA) between 2.0x and 2.5x - this was 2.0x at year-end 2014. It also takes account of the steps taken by management to support financial flexibility, including cost reduction, which is expected to mitigate EBITDA decline to CZK70 billion in 2015 vs. CZK72.5 billion in 2014.

At the same time, the negative outlook reflects that CEZ's credit metrics are weakly positioned against our guidance for the current rating level, including FFO / net debt above 30% and retained cash flow (RCF) / net debt above 20%, owing to the pressures on profitability discussed above. While lower prices will likely lead to a further reduction in operating cash flow from 2016 onwards as hedges roll off, we believe that CEZ has some capacity to absorb this through cuts to expenditure. This is underpinned by the company's capex program which includes a reduction from around CZK35-40 billion in 2014 and 2015 to less than CZK30 billion per annum between 2016 and 2019 as the investments designed to refurbish and upgrade the generation fleet will be completed by year-end 2015. CEZ's future financial profile will also depend on the dividend policy set by the government, which is currently based on a payout ratio of 50%-60%.

LARGE M&A AND/OR DEVELOPMENT OF NEW NUCLEAR WOULD BE CREDIT NEGATIVE

CEZ has publicly indicated that it would be interested in strengthening its footprint in CEE and confirmed that it might bid for Enel's 66% stake in Slovenkse Elektrarne as well as for Vatenfall's lignite power plants in Germany were these assets be put up for sale. Any acquisition of this scale would, if debt-funded, put pressure on CEZ's credit profile. However, CEZ's A2 rating currently does not factor in the potential impact of any of these transactions taking place given the very significant uncertainties surrounding their likelihood.

Separately, 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 A2 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 A2 rating incorporates one notch of uplift 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 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

CEZ's liquidity is strong, underpinned by CZK37 billion of cash and liquid financial assets as well as around CZK24 billion of undrawn committed facilities at year-end 2014. We believe that these sources, together with expected EBITDA of CZK70 billion in 2015, should be sufficient to meet the company's liquidity needs in the coming 12 months. These include dividends (which we expect to be in line with the 2014 level of CZK21 billion), capex of around CZK35-40 billion and debt maturities of CZK23 billion.

Rating Outlook

The outlook is negative, reflecting the risk that weak power prices could result in CEZ's key credit metrics falling permanently below our guidance for the current A2 rating, which includes FFO / net debt above 30% and RCF / net debt above 20%.

What Could Change the Rating - Up

Given the negative outlook on the ratings, we do not expect upwards rating pressure. Confirmation of the existing dividend policy would be necessary to consider stabilising the outlook.

What Could Change the Rating - Down

Negative pressure on CEZ's rating would develop if (1) we consider that recovery and maintenance of financial metrics at levels comfortably above guidance over the medium term is unlikely; (2) CEZ were to materially increase its dividend payout policy; (3) the group undertakes a large debt-funded acquisition; or (4) it starts developing new nuclear units that further weaken its financial profile.

Rating Factors

CEZ, a.s.

Unregulated Utilities and Unregulated Power Companies Industry Grid [1]	**Current as of 12/31/2014**		[2]**Moody's 12-18 Month Forward ViewAs of April 2015**	
Factor 1 : Scale (10%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale (USD Billion)	28	A		A
Factor 2 : Business Profile (40%)				
a) Market Diversification		Ba		Ba
b) Hedging and Integration Impact on Cash Flow Predictability		A		A
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)	7.3x	Baa	6x-8x	Baa
b) (CFO Pre-W/C) / Net Debt (3 Year Avg)	31.5%	Baa	30%-35%	Baa
c) RCF / Net Debt (3 Year Avg)	19.5%	Baa	17%-22%	Baa
Rating:				
a) Indicated Rating from Grid		Baa1		Baa1
b) Baseline Credit Assessment (BCA)		a3		a3

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment (BCA)	a3
b) Government Local Currency Rating	A1
c) Default Dependence	Moderate
d) Support	Strong
e) Final Rating Outcome	A2

[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

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