Moody's Investors Service

Credit Opinion: CEZ, a.s.

Global Credit Research - 24 Dec 2009

Prague, Czech Republic

Ratings

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

Contacts

Analyst	Phone
Richard Miratsky/Prague	420.224.222.929
Helen Francis/London	44.20.7772.5454
Monica Merli/London	

Key Indicators

CEZ, a.s.

	Dec-2008	Dec-2007	Dec-2006	Dec-2005
(CFO Pre-W/C + Interest) / Interest Expense	**13.4x**	**17.4x**	**14.0x**	**16.5x**
(CFO Pre-W/C) / Net Debt	**64.1%**	**78.0%**	**114.4%**	**104.0%**
(CFO Pre-W/C - Dividends) / Net Debt	**44.2%**	**62.9%**	**95.4%**	**88.6%**
(CFO Pre-W/C - Dividends) / Capex	**111.1%**	**160.7%**	**222.3%**	**265.0%**
Debt / Book Capitalisation	**37.5%**	**30.1%**	**26.1%**	**22.0%**
EBITA Margin %	**36.8%**	**32.2%**	**28.8%**	**24.5%**

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

Opinion

Corporate Profile

CEZ a.s. (CEZ) is one of the largest electric utilities in Central and Eastern Europe (CEE) and, with 9.2 million customers, is among the top ten European utilities. In addition to its core businesses - power production and trading (39% of the group revenues and 72% EBITDA as of Q3 2009); distribution and supply (57% and 15%, respectively) - the group is involved in mining and other activities, which complement the core business segments and contributed around 4% to total group revenues of EUR 6,7 billion in 2008.

Rating Rationale

CEZ's strong position within its A2 rating category is underpinned by the company's dominant position in the Czech Republic energy market, leading position within CEE and solid ranking among the top ten European electric utilities. CEZ's well-balanced vertical integration, with high coverage of fuel needs from its own coal mines and substantial downstream retail customer base served by its own distribution and supply subsidiaries, and good financial flexibility further support CEZ's strong position within its rating category. However, CEZ's rating is constrained by its ambitious south-east Europe focused M&A strategy and sizeable capex plan. Finally, CEZ's rating also includes one-notch uplift for potential government support, given the Czech government's controlling stake in the company.

Historically, CEZ has enjoyed significant financial flexibility, stemming from its strong financial profile and enabled by successful restructuring, strong operating performance and positive market development. CEZ has been largely insulated from the negative impact of the decline of electricity prices and consumption levels resulting from the worsening economic environment over 2009, due to the high proportion of generation capacity being sold on forward basis with prevailing one-year contracts. However, Moody's cautions that the main negative impact on CEZ's financial performance could occur during 2010. Moody's anticipates that such impact will result in the slow down of CEZ's profitability growth, rather than in any significant weakening of its credit metrics. Although Moody's recognises that CEZ's strong financial profile provides sizeable financial capacity for future capital investments and acquisitions, the agency cautions that CEZ's rating stability will depend on its ability and willingness to adjust its ambitious expansion strategy and capital investment programme in line with its operating and financial performance, which needs to remain within the ratio guidance of RCF/Net Debt of at least 30% and FFO interest coverage not less then 10x.

CEZ's rating is constrained by event risk associated with its ambitious M&A expansion strategy, which is focused on the higher risk, less stable regions of south-east Europe, and its sizeable capex plan aimed at the reconstruction, upgrade and expansion of its asset base. The disadvantage of a relatively higher share of CO2-intensive coal-based generation is partially mitigated by increasing utilisation of nuclear generation, significant ongoing investments in renewable energy (both international and domestic) and strategic plans to increase the share of gas-based generation in future. The EU derogation from the obligation to buy all CO2 emission permits from 2013 negotiated by Czech Republic further supports CEZ's position.

Given its substantial ownership by the government of the Czech Republic, CEZ falls within the scope of Moody's rating methodology for government-related issuers (GRIs). In accordance with the methodology, CEZ`s A2 issuer rating incorporates an uplift for potential government support to its standalone credit quality, which is expressed by Moody's as a Baseline Credit Assessment (BCA) of 7 (on a scale of 1 to 21, where 1 represents the lowest risk and 7 is equivalent to a A3 rating). The uplift to the BCA, currently at one notch, results from the credit quality of its government shareholder and Moody's assessment of medium probability of government support in the event of financial distress, as well as medium default dependence (i.e. degree of exposure to common drivers of credit quality).

When assessing CEZ's BCA, Moody's applies its Rating Methodology for Global Unregulated Utilities and Power Companies, which identifies key areas of focus for assessing the relative fundamental credit quality of unregulated utility companies. Based on CEZ's historical financial performance, the methodology grid indicates a BCA of 5, two notches above the assigned BCA of 7. Moody's expects the difference between the grid outcome and the actual BCA to narrow in the future; the significant decrease in electricity consumption in CEE and swift correction of energy prices will start impacting CEZ's financial performance and its challenging capital expenditure programme will test the company's balance sheet strength.

Rating Drivers

RATING FACTOR 1 - Market Assessment, Scale and Competitive Position

The A score within this factor reflects Moody's expectation that CEZ will retain its leading position within the Czech Republic's electricity market, despite continuing market liberalisation. Although fully liberalised, the Czech electricity market is significantly concentrated and dominated by vertically-integrated CEZ, with around a 73% market share in installed capacity and a 62% share in distribution. With a market capitalisation of EUR 14.2 billion and 9.2 million of customers, CEZ ranks among the top ten European electric utilities. Notwithstanding CEZ's well-entrenched position in the Czech market, Moody's does not regard a higher score in the Factor 1 than the selected A category as appropriate. The assigned score takes into account the relatively small size of CEZ's domestic market and the company's smaller asset base and generation capacity in comparison with peers in the wider European market.

RATING FACTOR 2 - Cash Flow Predictability and Business Model

The overall Baa score in the Factor 2 reflects Moody's positive view on CEZ's solid vertical integration, enabled by a high share of own up-stream coal reserves and a solid share in the down-stream segments through its own distribution companies and retail sales to households. However, the positive impact of sub-factor 2b, in which CEZ scores A, is offset by its ambitious investment programme aimed at asset replacement, extension of capacities and compliance with EU requirements, which commands a Ba score in the sub-factor 2c. Although the exposure to CO2 heavy, coal-based generation is balanced by nuclear generation capacities, the Baa score within sub-factor 2a reflects currently low share of renewable sources within CEZ's total electricity production. The Baa score in the sub-factor 2d reflects the relatively low contribution from low-risk regulated activities, commanded by the high level of liberalisation in the Czech electricity market and increasing exposure to higher-risk developing environments of south-east Europe.

RATING FACTOR 3 - Financial Policy

Moody's scores CEZ as Baa in this rating factor. As above 30% of CEZ's shares are listed, the company needs to balance the interests of both stockholders and creditors. CEZ's historically very solid financial performance enabled the company to gradually increase dividend pay-outs, reaching a target of a 50-60% pay-out ratio. Furthermore, the historically strong cash flow generation and relatively low level of indebtedness enabled CEZ to finalise a sizeable share buy-back aimed at optimising its capital structure in 2008. Due to increasing profitability and strong cash flow generation, the company has been historically successful in fulfilling its financial policy target ratios and remained well positioned within its targeted A2 rating category, despite the growing returns to shareholders and capital structure optimisation.

RATING FACTOR 4 - Financial Strength Metrics

CEZ's historical key credit metrics score Aaa/Aa in the methodology grid. CEZ's electricity generation business represents the most profitable segment of the group due to low marginal production costs. Although the electricity prices have retreated significantly from their high 2008 level of 80-90 EUR /MWh and electricity consumption decreased significantly due to the worsening economic environment, CEZ reported strengthening results for Q3 2009, mainly due to a high share of generation capacity sold on forward basis (mainly one-year contracts), thus benefiting from the high prices contracted during 2008. Moody's notes that the recent price and demand drops are likely to impact negatively CEZ's financial performance during 2010. However, Moody's anticipates such an impact to result in the slow down of the pace of CEZ's profitability growth, rather than in any significant weakening of its credit metrics. Despite the more challenging operating environment, Moody's recognises that CEZ's financial profile is very strong for its rating category and still provides sizeable financial capacity for future capital investments and acquisitions. However, Moody's cautions that CEZ's rating stability will depend on its ability and willingness to adjust its ambitious expansion strategy and capital investment programme in line with its operating and financial performance.

OTHER GRI FACTORS

Medium default dependence reflects the fact that CEZ generates the majority of its earnings in the Czech Republic, notwithstanding its electricity export business and acquisitions in Eastern Europe. In addition, CEZ is among the largest companies in the Czech Republic, representing a significant portion of the Czech economy, and is the largest corporate contributor to the state budget.

Medium support reflects CEZ's strategic importance to the Czech economy and the country's moderately interventionist government. Any impact of a potential reduction in state ownership on Moody's support assumption will depend on the government's rationale for disposing of its shares and the targeted final ownership. Moody's medium support assumption will not be impacted 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 group's expansion strategy.

Liquidity Profile

CEZ's liquidity situation is satisfactory, assuming that the company only pursues further acquisitions when the appropriate funding is in place. CEZ generates strong operating cash flow and has around CZK25 billion (EUR 1 billion) of headroom under its committed credit facilities, which are denominated in Czech korunas and euros. Moody's views positively CEZ's efforts to utilise the recent positive developments in the capital markets and revert a previous trend of an increasing portion of short-term debt in its capital structure by replacing its short-term bank financing with significantly longer-term bond issuance.

Moody's understand that CEZ's management has not currently detected any intentions from its relationship banks to reduce the current levels of credit facilities or to increase pricing. CEZ is in compliance with all its covenants applying to some of its credit facilities, agreed with local and major international financial institutions, with comfortable headroom. Despite a large capital expenditure programme and an increased dividend payout ratio at the 50-60% level, the company expects to continue to generate positive free cash flow.

Rating Outlook

The stable outlook reflects CEZ's strong operational cash flow and Moody's expectation that it will remain the leading electric utility in the Czech Republic. However, Moody's cautions that rating stability will depend on CEZ's ability and willingness to adjust its ambitious expansion strategy according to the development of its operating and financial performance.

What Could Change the Rating - Up

Given the high event risk associated with the company's ambitious M&A strategy, which has targeted EUR 4 billion of acquisitions in CEE, as well as the expected slowing of CEZ's growth trend due to anticipated impact of adverse market development, no upward movement in the rating is expected in the medium term.

What Could Change the Rating - Down

Any excessive acquisition strategy, sizeable share buy-back or large one-time dividend pay-out deemed unjustified in relation to cash flow growth, which would result in significant weakening of financial metrics below ratio guidance of RCF/Net Debt of at least 30% and FFO interest coverage not less than 10x, would exert downward pressure on the rating.

Rating Factors

CEZ, a.s.

Unregulated Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market Assessment, Scale and Competitive Position (25%)							
a) Size and scale (15%)			x				
b) Competitive position and market structure (10%)			x				
Factor 2: Cash Flow Predictability of Business Model (25%)							
a) Fuel strategy and mix (5%)				x			
b) Degree of integration and hedging strategy (5%)			x				
c) Capital requirements and operational performance (5%)					x		
d) Contribution from low/ high risk businesses (10%)				x			
Factor 3: Financial policy (10%)		x					
Factor 4: Financial Strength - Key Financial Metrics (40%)							
a) CFO pre-WC + Interest / Interest (10%)		x					
b) CFO pre-WC / Debt (12.5%)	x						
c) RCF / Debt (12.5%)	x						
d) FCF / Debt (5%)		x					
Rating:							
a) Methodology Implied BCA			**A1**				
b) Actual BCA			**A3**				

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