STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:
CEZ a.s.

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Summary:

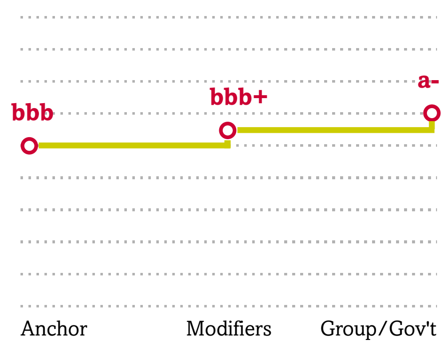
CEZ a.s.

Business Risk: STRONG

Vulnerable — Excellent

Financial Risk: SIGNIFICANT

Highly leveraged — Minimal



CORPORATE CREDIT RATING

A-/Stable/--

Rationale

Business Risk: Strong	Financial Risk: Significant
• Leading Czech vertically-integrated utility. • Low-cost, diverse, and competitive electricity generation fleet. • Rising share of stable, low-risk, and monopoly-regulated utility operations. • Exposure to competitive power markets and volatile wholesale power prices. • Nuclear operating risk.	• Adequate cash flow debt protection for the rating. • Increased dividend payout ratio. • Neutral to slightly positive discretionary cash flows.

Outlook: Stable

The stable outlook on Czech vertically-integrated utility CEZ a.s. reflects Standard & Poor's Ratings Services' view that CEZ will be able to maintain its strong market position in the Czech Republic, and respond to profit-margin pressure in the current weak market environment. We consider a ratio of Standard & Poor's-adjusted funds from operations (FFO) to debt of more than 25% as being commensurate with CEZ's current stand-alone credit profile (SACP) of 'bbb+'. However, all else being equal, and according to our methodology on government-related entities (GREs), a one-notch downward revision of CEZ's SACP would not affect the rating.

Downside scenario

Negative pressure on the SACP could result from weaker power prices and electricity generation spreads than we currently forecast, free CO2 allowances unexpectedly not being granted by the Czech government, or any large-scale acquisitions. In addition, signs of increased political risk--for example, policies that aim to extract cash from power utilities in the Czech Republic, either through dividends or windfall taxes--could have adverse implications for CEZ's profitability and, consequently, its SACP. Such evidence of negative government intervention could also lead us to reassess our opinion on extraordinary state support, and potentially lead to a lower rating.

Upside scenario

We could revise the SACP upward if CEZ were able to maintain its ratio of adjusted FFO to debt at more than 35%. This could happen if power market fundamentals in domestic and Western European markets were to unexpectedly and sustainably improve, and if CEZ continued to focus on its core domestic business and refrained from opportunistic acquisitions. All else being equal, and according to our methodology on GREs, a one-notch upward revision of CEZ's SACP would translate into a similar improvement in the rating.

Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics

Assumptions

- Electricity demand trending in line with our forecasts for GDP growth in the eurozone of 1.5% in 2015 and 1.7% in 2016.
- Declining forward power prices as indicated by the market exchange for Central European power generation. Actual power prices are applied to hedged output.
- Profit margins weakening in the long run, due to CEZ's need to procure a proportion of its carbon requirement permits on the market.

Key Metrics

	2014A	2015f	2016f
FFO to debt (%)	33.8	27-32	27-32
FFO interest coverage (x)	9.4	9-11	9-11
DCF to debt (%)	7.0	1-3	3-6

*Fully Standard & Poor's-adjusted. A--Actual as of Dec. 31, 2014. E--Estimate. DCF--Discretionary cash flows. FFO--Funds from operations. Reported figures are adjusted for capitalized interest, surplus cash, asset retirement obligations, minority interest, and accruals. We deduct from FFO mark-to-market on commodity derivatives and the amortization of the cost of nuclear fuel.

Business Risk: Strong

Our view of CEZ's "strong" business risk profile is based on the fact that the company generates more than 90% of its EBITDA in Central Europe, which we see as having "moderately high" country risk. Following a forced exit from Albania, and in line with its consolidation strategy, CEZ is now exposed far less to credit dilution from "high risk" Eastern Europe countries. Our view captures the fact that CEZ derives more than 70% of its cash flows from its vertically integrated activities in mining, as well as the generation, trading, and sale of electricity. We view these activities as having "moderately high" risk due to their exposure to inherently volatile wholesale power markets. This is partly offset by the increasing proportion of revenues from the company's low-risk, regulated distribution network businesses, which we believe will exceed 25% of EBITDA in the near term.

In our view, CEZ benefits from its strong market position as a leading generator and supplier of electricity in the Czech Republic. We also recognize that CEZ is able to capture value across the energy chain as an integrated utility from lignite coal mining through to the generation, distribution, and retail sale of electricity. A further rating strength is the company's competitive, low-cost, and multi-fueled electricity generation fleet. Constraints include the nuclear operating risk related to one-quarter of CEZ's installed capacity.

We assess CEZ's profitability as "adequate" for an unregulated power and gas company. Although CEZ has posted above-peer-average EBITDA margins in the past, we anticipate that profit margins will be pressured over the longer term by increased carbon emissions costs. That said, these costs will be lower than for some peers because the Czech Republic was granted a portion of free, although gradually declining, carbon dioxide emission allowances from 2013 to 2019.

Financial Risk: Significant

CEZ's "significant" risk profile is supported by our forecast of declining but adequate cash flow metrics. We anticipate that CEZ will post adjusted FFO to debt with some headroom under our rating guideline of above 25%, which is at the upper end of the "significant" financial risk profile category (using the standard volatility table in our "Corporate Methodology," published Nov. 19, 2013). One of the constraints on CEZ's financial risk profile is our expectation of neutral to slightly positive discretionary cash flows (cash flows after capital expenditures [capex] and dividends) in the coming years, which we see as commensurate with an "aggressive" financial risk profile. Furthermore, we see the potential for large-scale acquisitions to not only erode CEZ's credit metrics, but also to weaken CEZ's business risk profile depending on the nature of the acquired business and the complexity and scale of CEZ's future investment program.

Liquidity: Adequate

We view CEZ's liquidity position as "adequate," under our criteria, as we anticipate that available liquidity resources will cover expected cash outflows by more than 1.2x in the next 12 months.

Principal Liquidity Sources	Principal Liquidity Uses
• Unrestricted cash and securities of Czech koruna (CZK) 29.1 billion (about €1.1 billion) as of March 31, 2015, according to management data. • Available headroom of about CZK29.1 billion under various committed back-up facilities, all with an option to draw down for another year, and more than one-third of which have a final draw date of more than two years. • FFO of about CZK55 billion over the 12 months to March 31, 2016.	• Debt maturities of about CZK16 billion over the 12 months to March 31, 2016. • Annual capex of about CZK30 billion. • A dividend payout ratio of 60%-80% of 2014 adjusted profits, or about CZK20 billion.

Other Credit Considerations

We revise CEZ's anchor upward by one notch to reflect a positive comparable rating analysis modifier. This is based on our forecasts that CEZ will maintain its credit metrics at the upper end of the "significant" financial risk profile category when judged by the core ratio of adjusted FFO to debt. We assess CEZ's management and governance as "satisfactory."

Government Influence

We view CEZ as having an "important" role for the Czech government as both a provider of an essential service and a key player in the implementation of state energy policies. The company produces more than 70% of the domestic power output, which is sufficient to cover domestic consumption requirements, and distributes electricity to more than 60% of customers in the Czech Republic.

We see the company's link to the Czech government as "strong," as the latter is actively 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. Although the state may eventually sell part of its stake in CEZ to fund state pension reforms, we understand that the current government is not contemplating such an action at present. We anticipate that the state will retain its strategic control over CEZ and will remain a supportive shareholder by avoiding negative interventions, such as raising the dividend payout ratio or implementing windfall taxes on power companies.

Ratings Score Snapshot

Corporate 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 (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Positive (+1 notch)

Stand-alone credit profile : bbb+

- **Related government rating:** AA
- **Likelihood of government support:** Moderately high (+1 notch from SACP)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: May 2015, May 29, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	**bbb**	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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