

Research

CEZ a.s.

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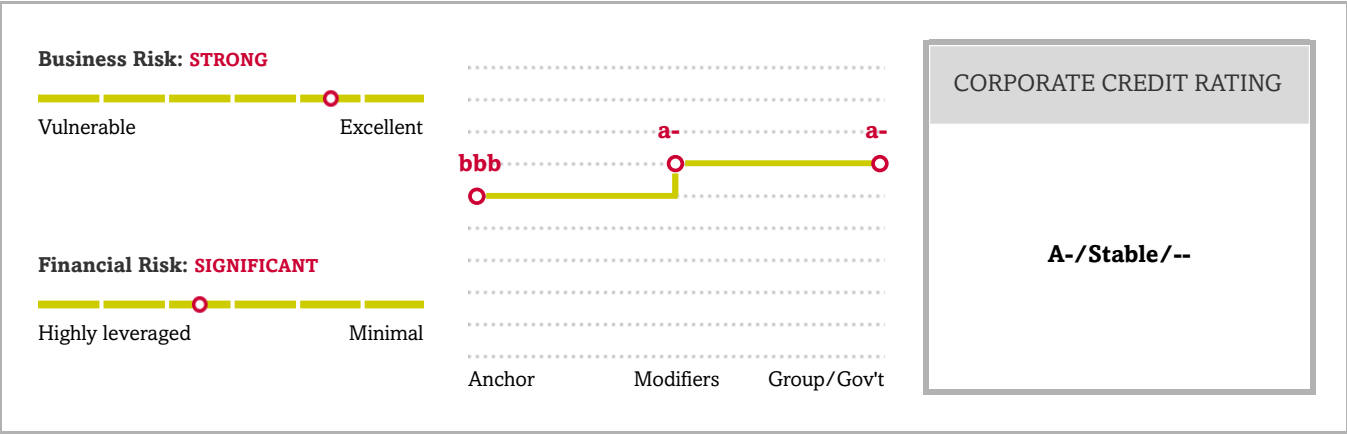
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CEZ a.s.



Rationale

Business Risk: Strong	Financial Risk: Significant
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> • Adequate cash flow debt protection for the rating level. • Neutral to slightly positive discretionary cash flows.

Outlook: Stable

The stable outlook reflects our view that CEZ will be able to maintain its strong market position in the Czech Republic, and that it can 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 the current 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 corporate credit rating.

Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none">Electricity demand trending in line with our forecasts for GDP growth for the eurozone of 0.8% in 2014 and 1.0% in 2015.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.		2013A	2014E	2015E
	FFO to debt (%)	37.5	30-35	27-32
	FFO interest cover (x)	10.4	9-11	9-11
	DCF to debt (%)	3.3	0-2	1-3
<p>*Fully Standard & Poor's-adjusted. A—Actual as of Dec. 31, 2013. E--Estimated. DCF—Discretionary cash flows; FFO--Funds from operations; 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.</p>				

Company Description

CEZ is a Czech Republic-based vertically integrated power utility with a strong position in each of its key areas of operation: power generation, with 15,199 megawatts of installed production capacity; regulated distribution activities; and supply. The company has about a 72% market share of the generation segment in the Czech Republic, and its activities are supported by its ownership of the Czech Republic's largest mining company, which provides 73% of CEZ's lignite needs. CEZ controls about 64% of the Czech Republic's electricity distribution, owning the largest distribution company in the Czech Republic. It also has an overall market share of 37% in the competitive Czech supply market. During its expansion phase between 2004 and 2009, CEZ acquired assets across the value chain in neighboring electricity markets, specifically in Bulgaria, Romania, Poland, and Albania. In 2013, the contribution by fully consolidated foreign subsidiaries was limited to about 7% of EBITDA. In October 2014, CEZ and the Albanian government mutually agreed to assign a 76% stake in the distribution company back to the Albanian state.

Business Risk: Strong

Our view of CEZ's "strong" business risk profile is based on the fact that it generates more than 90% of its EBITDA in Central Europe, which we see as "moderately high" in terms of 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 the 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. Further rating strength comes from 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.

S&P Base-Case Operating Scenario

- Our forecast real GDP growth in the Czech Republic of 2.6% in 2014 and 3.3% in 2015.
- Gradually declining total EBITDA due to declining power prices as a result of the subdued economic outlook for the eurozone, electricity generation oversupply, and low carbon and coal prices.
- Cost savings with target to save 16% of overall fixed costs annually over the next couple of years.
- Contribution of regulated distribution including foreign operations between 2014-2019 to rise from 25% to 30% of the total EBITDA.

Peer comparison

Table 1

CEZ a.s. -- Peer Comparison				
Industry Sector: Electric Utility				
	CEZ a.s.	Fortum Oyj	DONG Energy A/S	Verbund AG
	A-/Stable	A-/Negative/A-2	BBB+/Stable/A-2	BBB+/Stable
--Fiscal year ended Dec. 31, 2013--				
(Mil. €)				
Revenues	8,143.0	6,056.0	9,799.0	3,181.6
EBITDA	3,320.8	2,420.0	2,128.2	1,394.5
Funds from operations (FFO)	2,691.6	1,833.4	1,483.0	1,132.9
Net income from cont. oper.	1,310.4	1,204.0	(209.4)	931.3
Cash flow from operations	2,565.4	1,860.4	1,264.0	867.7
Capital expenditures	1,547.8	1,271.0	2,782.3	543.5
Free operating cash flow	1,017.6	589.4	(1,518.3)	324.2
Dividends paid	779.1	888.0	45.2	305.5
Discretionary cash flow	238.5	(298.6)	(1,563.5)	18.6
Debt	7,169.9	9,319.8	6,053.8	4,434.9
Preferred stock	0.0	0.0	(887.1)	0.0
Equity	9,608.5	10,563.9	6,021.7	6,231.9
Debt and equity	16,778.4	19,883.7	12,075.6	10,666.8
Adjusted ratios				
EBITDA margin (%)	40.8	40.0	21.7	43.8
Return on capital (%)	10.4	8.1	7.3	3.3

Table 1

CEZ a.s. -- Peer Comparison (cont.)				
EBITDA interest coverage (x)	9.8	5.8	4.9	6.1
FFO cash int. cov. (X)	10.4	6.0	2.2	7.2
Debt/EBITDA (x)	2.2	3.9	2.8	3.2
FFO/debt (%)	37.5	19.7	24.5	25.5
Cash flow from operations/debt (%)	35.8	20.0	20.9	19.6
Free operating cash flow/debt (%)	14.2	6.3	(25.1)	7.3
Discretionary cash flow/debt (%)	3.3	(3.2)	(25.8)	0.4
Net cash flow / capex (%)	123.6	74.4	51.7	152.2
Return on capital (%)	10.4	8.1	7.3	3.3
Return on common equity (%)	12.1	11.9	(4.2)	19.5
Common dividend payout ratio (un-adj.) (%)	59.5	73.8	(43.2)	22.4

N.M. - Not Meaningful.

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 to our rating guideline of above 25%, which is at the upper end of a "significant" financial risk profile (using the standard volatility table). One of the constraints is our expectation of neutral to slightly positive discretionary cash flows (cash flows after capital expenditures and dividends) in the coming years, which we see as commensurate with an "aggressive" financial risk profile. Furthermore, we could see large scale acquisitions such as Slovenske Elektrarne as not only eroding credit metrics, but also possibly negatively impacting CEZ's business risk profile depending on the acquired business and the complexity and scale of its future investment program.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Adjusted FFO to remain close to 30% in the 2014 and 2015 but decline thereafter on the back of lower power prices. Revenues are based on hedged volumes at hedged prices. Czech power prices and CO2 assumptions continue to be driven by the German power market.
- Positive free operating cash flows as capital expenditure is significantly scaled down compared to the past.
- Neutral to slightly positive discretionary cash flows, resulting in a slight decrease in debt levels over the rating horizon.
- Dividend payout ratio to remain stable at 50%-60% of net profits.
- Uncertainty as to potential bid for Slovenske Elektrarne. We have not factored this acquisition in our base case scenario as CEZ has not yet submitted a formal binding bid.

Financial summary

Table 2

CEZ a.s. -- Financial Summary					
Industry Sector: Electric Utility					
	--Fiscal year ended Dec. 31--				
	2013	2012	2011	2010	2009
Rating history	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--
(Mil. CZK)					
Revenues	222,992.0	213,719.0	208,527.0	199,128.0	199,007.0
EBITDA	90,938.0	86,995.0	89,376.0	92,933.0	96,618.0
Funds from operations (FFO)	73,708.8	69,356.2	71,356.1	76,666.7	79,685.6
Net income from continuing operations	35,885.0	41,429.0	40,756.0	47,051.0	51,547.0
Cash flow from operations	70,251.8	62,608.2	60,381.1	75,719.7	86,437.6
Capital expenditures	42,385.0	49,902.0	50,348.0	59,984.0	68,710.0
Free operating cash flow	27,866.8	12,706.2	10,033.1	15,735.7	17,727.6
Dividends paid	21,336.0	23,995.0	26,655.0	28,783.0	26,561.0
Discretionary cash flow	6,530.8	(11,288.8)	(16,621.9)	(13,047.3)	(8,833.4)
Debt	196,343.2	202,103.1	198,284.5	185,854.5	173,776.8
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	263,125.0	254,219.0	232,078.0	227,052.0	206,675.0
Debt and equity	459,468.2	456,322.1	430,362.5	412,906.5	380,451.8
Adjusted ratios					
EBITDA margin (%)	40.8	40.7	42.9	46.7	48.6
EBITDA interest coverage (x)	9.8	9.6	10.0	12.3	15.0
FFO cash int. cov. (x)	10.4	10.2	11.1	14.9	21.4
Debt/EBITDA (x)	2.2	2.3	2.2	2.0	1.8
FFO/debt (%)	37.5	34.3	36.0	41.3	45.9
Cash flow from operations/debt (%)	35.8	31.0	30.5	40.7	49.7
Free operating cash flow/debt (%)	14.2	6.3	5.1	8.5	10.2
Discretionary cash flow/debt (%)	3.3	(5.6)	(8.4)	(7.0)	(5.1)
Net Cash Flow / Capex (%)	123.6	90.9	88.8	79.8	77.3
Return on capital (%)	10.9	12.7	13.6	16.6	21.1
Return on common equity (%)	12.7	15.9	16.9	20.9	26.5
Common dividend payout ratio (un-adj.) (%)	59.5	57.9	65.4	60.0	41.2
N.M. - Not Meaningful.					

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
<ul style="list-style-type: none"> Unrestricted cash and securities of CZK23.5 billion (about €850 million) as of Sept. 30, 2014, according to management data. Available headroom of about CZK25.5 billion under various committed back-up facilities, all with an option to draw down for another year and more than one-third of which has a final draw date of more than two years. FFO of about CZK58 billion over the next 12 months to Sept. 30, 2015. 	<ul style="list-style-type: none"> Debt maturities of about CZK23 billion over the next 12 months to Sept. 30, 2015. Annual capital expenditure of about CZK30 billion. Dividend payout ratio of 50%-60% of 2013 profits, or about CZK20.0 billion.

Debt maturities

Maturity profile (CZK mil.)	
2014	30,820
2015	19,394
2016	16,632
2017	2,835
2018	2,784
Thereafter	126,751

Other Modifiers

We apply a positive comparable rating analysis modifier based on our forecasts that CEZ will maintain its credit metrics at the upper end of the "significant" range when judged by the core ratio of adjusted FFO to debt. We assess the group'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.

Reconciliation

Table 3

Reconciliation Of CEZ a.s. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CZK)										
--Fiscal year ended Dec. 31, 2013--										
CEZ a.s. reported amounts										
	Debt	Shareholders' equity	Revenues	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations	Dividends paid	Capital expenditures
Reported	199,216	258,076	217,273	82,121	45,755	4,569	82,121	72,556	21,336	46,076
Standard & Poor's adjustments										
Interest expense (reported)	--	--	--	--	--	--	(4,569)	--	--	--
Interest income (reported)	--	--	--	--	--	--	1,439	--	--	--
Current tax expense (reported)	--	--	--	--	--	--	(9,434)	--	--	--
Surplus cash	(36,942)	--	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	3,691	(3,691)	(3,691)	--	(3,691)
Share-based compensation expense	--	--	--	33	--	--	33	--	--	--
Asset retirement obligations	30,328	--	--	--	--	1,014	(974)	1,387	--	--
Non-operating income (expense)	--	--	--	--	473	--	--	--	--	--
Non-controlling Interest/Minority interest	--	5,049	--	--	--	--	--	--	--	--
Debt - Accrued interest not included in reported debt	3,741	--	--	--	--	--	--	--	--	--
Revenues - Other	--	--	5,719	5,719	5,719	--	5,719	--	--	--
EBITDA - Other	--	--	--	3,065	3,065	--	3,065	--	--	--
D&A - Other	--	--	--	--	(3,065)	--	--	--	--	--
Total adjustments	(2,873)	5,049	5,719	8,817	6,192	4,705	(8,412)	(2,304)	0	(3,691)
Standard & Poor's adjusted amounts										
	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends paid	Capital expenditures
Adjusted	196,343	263,125	222,992	90,938	51,947	9,274	73,709	70,252	21,336	42,385

Related Criteria And Research

- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 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
- 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
- Rating Government-Related Entities: Methodology and Assumptions, Dec. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

Business Risk Profile	Financial 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-

Ratings Detail (As Of December 17, 2014)

CEZ a.s.

Corporate Credit Rating A-/Stable/--
 Senior Unsecured A-

Corporate Credit Ratings History

02-Oct-2006 A-/Stable/--
 31-May-2005 BBB+/Positive/--
 12-Nov-2003 BBB+/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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