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McGRAW HILL FINANCIAL

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CEZ a.s.

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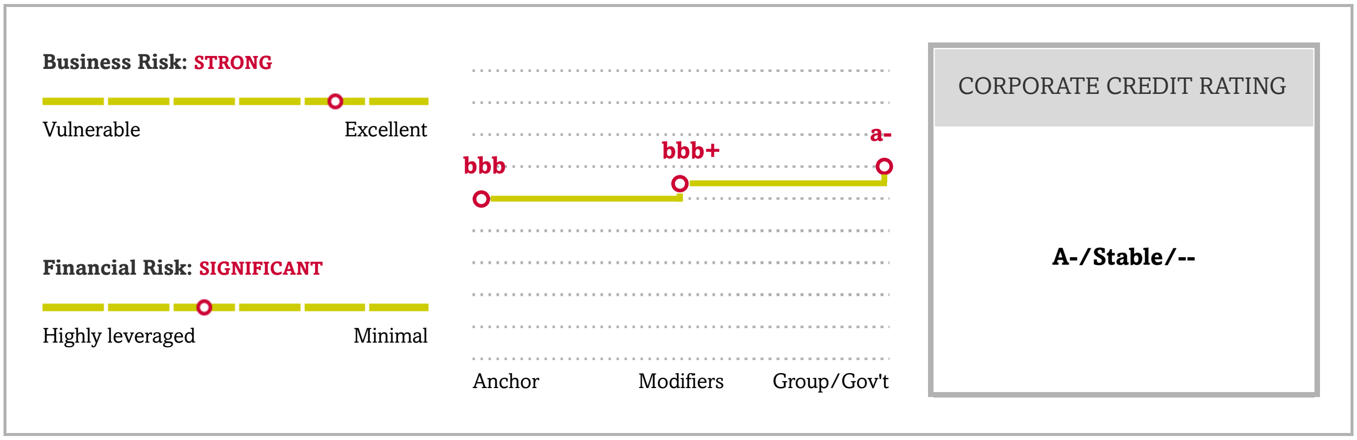

Rationale

Business Risk: Strong	Financial Risk: Significant
• Leading Czech vertically-integrated utility. • Low-cost, diverse, and competitive electricity generation fleet. • Exposure to competitive power markets and volatile wholesale power prices, as well as carbon prices. • Nuclear operating risk. • Supportive energy policy resulting from ongoing support from the government.	• Adequate cash flow debt protection for the rating level. • Increased dividend payout ratio. • Neutral to slightly positive discretionary cash flows. • Appetite for large external growth opportunities.

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, including the announced interest for Vattenfall's German hydro and lignite generation portfolio. In addition, acquisition of foreign assets and 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, a one-notch upward revision of CEZ's SACP would translate into a similar improvement for the rating.

Standard & Poor's Base-Case Scenario

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Assumptions
• Electricity demand trending in line with our forecasts for GDP growth in the eurozone of 1.8% in 2016 and 1.6% in 2017. • Forecast real GDP growth in Czech Republic of 2.5% per year in 2015-2018. • Profit margins weakening in the long run, due to CEZ's need to procure a proportion of its carbon requirement permits on the market. • Declining forward power prices as indicated by the market exchange for Central European power generation. • Easing of coal mining limits which ensures security of supply.

Key Metrics

	2014A	2015E	2016E
FFO to debt (%)	33.8	30.0-35.0	30.0-35.0
FFO interest cover (x)	9.4	9.0-11.0	9.0-11.0
DCF to debt (%)	8.1	2.0-5.0	2.0-5.0

FFO--Funds from operations. DCF--Discretionary cash flow. A--Actual. E--Estimate.

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 16,038 megawatts of installed production capacity; regulated distribution activities; and supply. The company has about a 68% 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 71% of CEZ's lignite needs. CEZ controls about 61% 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. Regulated operations contributed to about 26% of 2014 EBITDA. The largest shareholder of CEZ is the Czech Republic, with a stake of nearly 70% in the company's share capital.

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 in 2014, CEZ is now less exposed to operations in high risk Eastern European countries. Our assessment of CEZ's business risk profile also captures the fact that the company derives more than 70% of its cash flows from its vertically integrated activities in mining, generation, trading, and the 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 company's low-risk, regulated distribution network businesses, which represent about 26% of EBITDA. However, we believe that any large scale potential acquisition of unregulated assets could prove to be credit dilutive as it would bring the share of regulated activities down and potentially weaken the business risk profile. This is notably the case for CEZ's announced interest in Vattenfall's generation portfolio in Germany. We currently do not consider this transaction as a part of our base-case scenario given that the the deal process is in its early stages and the potentially significant implications on CEZ's credit quality should CEZ win the bid and decide to go ahead with it. Notably, if CEZ acquires these assets, its regulated activities would decrease substantially, which could lead us to the revise its business risk profile downward.

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. In the latter half of 2015, the Czech Government approved the easing of mining limits of Bílina mine, owned by CEZ Group, which we view as a positive development. A further rating strength is the company's competitive, low-cost, and multi-fueled electricity generation fleet. Constraints include the group's exposure to nuclear operating risk. Nuclear represents one-quarter of CEZ's installed capacity.

We assess CEZ's profitability as adequate for an unregulated power and gas company. We anticipate that profit margins will be constrained 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 2013-2019.

S&P Base-Case Operating Scenario

- 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.
- Comprehensive cost cutting and plans to save 16% of overall fixed operating costs in 2015 and 2016, which is included in our forecast.
- One-off gain in operating income for 2015 amounting to Czech koruna (CZK) 3.8 billion of gift tax on emission allowances paid in 2011 and 2012.

Peer comparison

Table 1

CEZ a.s. -- Peer Comparison

Industry Sector: Electric Utility

	CEZ a.s.	**Fortum Oyj**	**DONG Energy A/S**	**Verbund AG**
Rating as of Dec. 2, 2015	A-/Stable/(A-2)	BBB+/Stable/A-2	BBB+/Stable/A-2	BBB+/Stable/(A-2)
	--Fiscal year ended Dec. 31, 2014--	**--Fiscal year ended Dec. 31, 2014--**	**--Fiscal year ended Dec. 31, 2014--**	**--Fiscal year ended Dec. 31, 2014--**
(Mil. €)				
Revenues	7,398.5	4,751.0	9,003.1	2,825.5
EBITDA	2,817.7	1,966.0	2,042.1	973.0
Funds from operations (FFO)	2,297.7	1,517.5	941.4	721.6
Net income from cont. oper.	808.2	3,154.0	(320.7)	101.1

Table 1

CEZ a.s. -- Peer Comparison (cont.)				
Cash flow from operations	2,462.4	1,774.5	2,025.8	739.7
Capital expenditures	1,145.1	768.0	1,919.1	443.4
Free operating cash flow	1,317.4	1,006.5	106.7	296.4
Discretionary cash flow	548.3	29.5	56.1	(122.0)
Cash and short-term investments	192.0	448.0	0.0	(234.5)
Debt	6,796.6	5,957.3	3,415.5	3,964.4
Equity	9,590.3	10,935.0	7,373.9	6,025.1
Adjusted ratios				
EBITDA margin (%)	38.1	41.4	22.7	34.4
Return on capital (%)	8.1	8.0	5.8	5.0
EBITDA interest coverage (x)	8.8	5.5	4.7	4.7
FFO cash int. cov. (X)	9.4	5.7	1.7	4.0
Debt/EBITDA (x)	2.4	3.0	1.7	4.1
FFO/debt (%)	33.8	25.5	27.6	18.2
Cash flow from operations/debt (%)	36.2	29.8	59.3	18.7
Free operating cash flow/debt (%)	19.4	16.9	3.1	7.5
Discretionary cash flow/debt (%)	8.1	0.5	1.6	(3.1)

Financial Risk: Significant

CEZ's significant financial 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, as explained above, we consider the potential acquisition of Vattenfall's generation (lignite and hydro) assets in Germany as an event risk, that could not only erode credit metrics, but also weigh on CEZ's business risk profile.

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

- Revenues are based on hedged volumes at hedged prices. Czech power prices continue to be driven by the German power market and we do not expect a major pick-up in carbon price over the next two years.
- Increase in the dividend pay-out ratio to 60%-80%.
- Due to lack of investment projects, we forecast positive discretionary cash flows which we assume will be used for debt repayment.
- Capital expenditure (capex) will decrease close to CZK30 billion per year from 2016 onward. Capex is not driven by a decision on nuclear new build anymore as two new units in Temelin were not given the green light.
- Uncertainty as to the potential acquisition of Vattenfall's generation (lignite and hydro) assets in Germany. We have not factored this acquisition into 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--				
	2014	**2013**	**2012**	**2011**	**2010**
Rating history	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--
(Mil. CZK)					
Revenues	205,092.0	222,992.0	213,719.0	208,527.0	199,128.0
EBITDA	78,109.0	90,938.0	86,995.0	89,376.0	92,933.0
Funds from operations (FFO)	63,692.8	73,708.8	69,356.2	71,356.1	76,666.7
Net income from continuing operations	22,403.0	35,885.0	41,429.0	40,756.0	47,051.0
Cash flow from operations	68,260.8	70,251.8	62,608.2	60,381.1	75,719.7
Capital expenditures	31,742.0	42,385.0	49,902.0	50,348.0	59,984.0
Free operating cash flow	36,518.8	27,866.8	12,706.2	10,033.1	15,735.7
Dividends paid	21,320.0	21,336.0	23,995.0	26,655.0	28,783.0
Discretionary cash flow	15,198.8	6,530.8	(11,288.8)	(16,621.9)	(13,047.3)
Debt	188,408.4	196,343.2	202,103.1	198,284.5	185,854.5
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	265,851.0	263,125.0	254,219.0	232,078.0	227,052.0
Debt and equity	454,259.4	459,468.2	456,322.1	430,362.5	412,906.5
Adjusted ratios					
EBITDA margin (%)	38.1	40.8	40.7	42.9	46.7
EBITDA interest coverage (x)	8.8	9.8	9.6	10.0	12.3
FFO cash int. cov. (x)	9.4	10.4	10.2	11.1	14.9
Debt/EBITDA (x)	2.4	2.2	2.3	2.2	2.0
FFO/debt (%)	33.8	37.5	34.3	36.0	41.3
Cash flow from operations/debt (%)	36.2	35.8	31.0	30.5	40.7
Free operating cash flow/debt (%)	19.4	14.2	6.3	5.1	8.5
Discretionary cash flow/debt (%)	8.1	3.3	(5.6)	(8.4)	(7.0)

Table 2

CEZ a.s. -- Financial Summary (cont.)					
Net cash flow / capex (%)	133.5	123.6	90.9	88.8	79.8
Return on capital (%)	8.1	10.9	12.7	13.6	16.6
Return on common equity (%)	7.1	12.7	15.9	16.9	20.9
Common dividend payout ratio (un-adj.) (%)	95.2	59.5	57.9	65.4	60.0

Liquidity: Adequate

We view CEZ's liquidity position as adequate because we anticipate that available liquidity sources will cover expected liquidity uses by more than 1.2x in the next 12 months.

Principal Liquidity Sources	Principal Liquidity Uses
• Unrestricted cash and securities of CZK29.2 billion as of Sept. 31, 2015, according to management data; • Available headroom of about CZK27.5 billion under various committed back-up facilities, all with an option to draw down for another year, and more than one-third of which have a final draw date of more than two years; and • FFO of about CZK60 billion.	• Debt maturities of about CZK12 billion over the next 12 months to Sept. 31, 2015; • Annual capex of about CZK33 billion-CZK35 billion as per the company's guidance; and • Dividend payout ratio of 72%-80%, about CZK20 billion-CZK21 billion in the next 12 months.

Debt maturities

2015: 23,282 million

2016: 11,518 million

2017: 15,845 million

2018: 2,010 million

2019: 3,390 million

Thereafter: 128,089 million

Other Credit Considerations

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.

Government Influence

We believe that there is a moderately high likelihood that the Czech Republic would provide timely and sufficient extraordinary support to CEZ in the event of financial distress. We base our opinion on our assessment of CEZ's important role for, and strong link with, the Czech government.

- 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, because the government 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)

Reconciliation

Table 3

Reconciliation Of CEZ a.s. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CZK)

	--Fiscal year ended Dec. 31, 2014--								
CEZ a.s. reported amounts									
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
Reported	184,134	261,308	200,657	72,676	36,946	3,650	72,676	70,920	35,798
Standard & Poor's adjustments									
Interest expense (reported)	--	--	--	--	--	--	(3,650)	--	--
Interest income (reported)	--	--	--	--	--	--	608	--	--
Current tax expense (reported)	--	--	--	--	--	--	(6,099)	--	--
Surplus cash	(30,152)	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	4,056	(4,056)	(4,056)	(4,056)
Share-based compensation expense	--	--	--	26	--	--	26	--	--
Asset retirement obligations	31,469	--	--	--	--	1,204	(1,219)	1,397	--
Non-operating income (expense)	--	--	--	--	(323)	--	--	--	--
Non-controlling Interest/Minority interest	--	4,543	--	--	--	--	--	--	--
Debt - Accrued interest not included in reported debt	2958	--	--	--	--	--	--	--	--
Revenues - Other	--	--	4,435	4,435	4,435	--	4,435	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	--	178	178	--	178	--	--
EBITDA - Other	--	--	--	794	794	--	794	--	--
D&A - Other	--	--	--	--	(3,356)	--	--	--	--
Total adjustments	4,274	4,543	4.435	5,433	1,728	5,260	(8,983)	(2,659)	(4,056)

Table 3

Reconciliation Of CEZ a.s. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CZK) (cont.)

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Capital expenditures
Adjusted	188,408	265,851	205,092	78,109	38,674	8,910	63,693	68,261	31,742

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

Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013

Methodology: Industry Risk, Nov. 19, 2013

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Corporate Methodology, Nov. 19, 2013

Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013

Group Rating Methodology, 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

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-

Ratings Detail (As Of December 11, 2015)	
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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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