MOODY'S INVESTORS SERVICE

CREDIT OPINION
12 May 2017

Update

Rate this Research

RATINGS

CEZ, a.s.

Domicile	Czech Republic
Long Term Rating	Baa1
Type	Senior Unsecured - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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CEZ, a.s.

Update to Discussion of Key Credit Factors

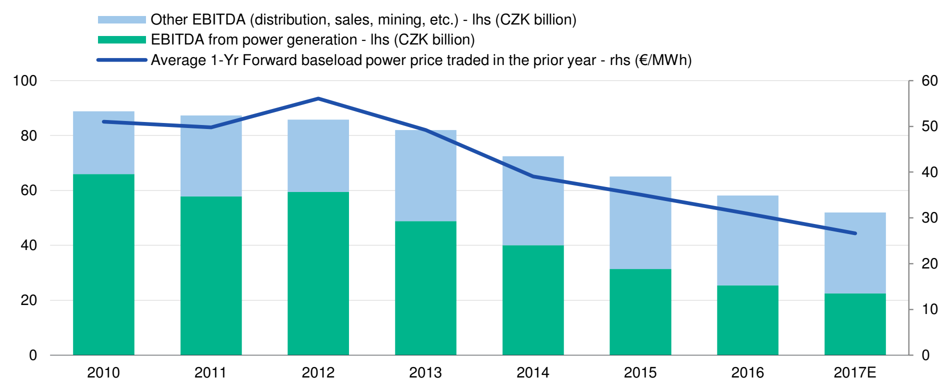
Summary Rating Rationale

CEZ's Baa1 rating is supported 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 power generation fleet; and (3) the cash flow stability stemming from its Czech regulated distribution activities, which accounted for 30% of EBITDA in 2016. At the same time, these factors are balanced by (1) the current low power price environment which weighs on the group's profitability given the predominantly fixed-cost nature of its traditional power generation business, which accounted for 38% of EBITDA in 2016; and (2) the challenges and execution risks associated with CEZ's strategy to expand in renewables and energy services.

From the financial risk perspective, the Baa1 rating reflects our expectation of broadly stable credit metrics in the medium term as the anticipated decline in earnings is mitigated by positive free cash flows stemming from a moderate capex programme. Current financial ratios are in line with the guidance for the Baa1 rating, with funds from operations (FFO)/net debt of 27% at year-end 2016.

Exhibit 1

CEZ's EBITDA continues to decline along power prices



Source: Moody's Investors Service

Finally, the Baa1 rating incorporates one notch of rating uplift given the Czech government's 70% ownership.

Credit Strengths

» CEZ's generation fleet in Czechia is mostly low-cost nuclear and lignite

» Regulated network distribution activities support cash flow stability

» Moderate capex programme results in positive free cash flows

» Ownership by the Czech government (A1 stable)

Credit Challenges

» Large exposure to fixed-cost, merchant power generation in Czechia, which makes the company particularly exposed to current low power prices

» Strategy to invest, among other, in renewables creates execution risk given CEZ's historically limited exposure to this business

» Long-term uncertainty surrounding the development of new nuclear plants in Czechia

Rating Outlook

The outlook is stable, reflecting our expectation that CEZ's key credit metrics will remain aligned with the guidance for the current Baa1 rating, which includes FFO/net debt around the mid twenties in percentage terms and RCF/net debt in the high teens in percentage terms.

Factors that Could Lead to an Upgrade

» Higher than expected power prices or a moderate dividend policy resulting in FFO/net debt sustainably in the high twenties to low thirties in percentage terms and RCF/net debt comfortably above 20% on a sustainable basis, could exert upward pressure on ratings.

Factors that Could Lead to a Downgrade

» Financial ratios falling permanently below our guidance for the Baa1 rating;

» The group undertakes a large debt-funded acquisition in addition to its announced potential investments;

» CEZ starts developing new nuclear units that weaken its business and/or financial risk profile.

Key Indicators

Exhibit 2

CEZ's key adjusted indicators

	12/31/2016	12/31/2015	12/31/2014	12/31/2013	12/31/2012
(CFO Pre-W/C + Interest) / Interest	8.3x	8.7x	7.4x	7.3x	8.3x
(CFO Pre-W/C) / Net Debt	27.5%	35.9%	31.5%	31.9%	35.0%
RCF / Net Debt	15.3%	22.5%	19.6%	20.7%	22.4%
All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.					

Source: Moody's Financial Metrics

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

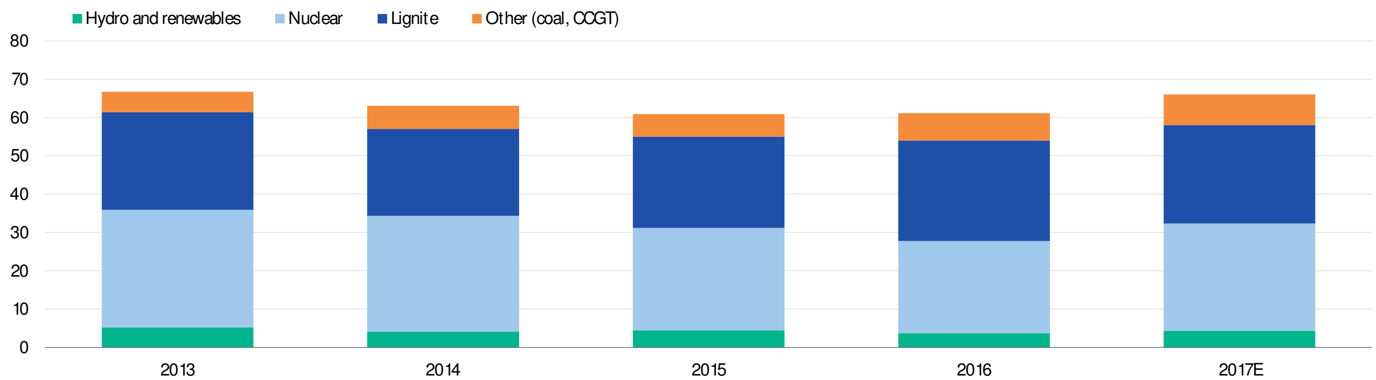
Detailed Rating Considerations

Fixed-cost generation fleet impacted by low power prices

With around 13 gigawatts (GW) of installed capacity, CEZ is the largest generator in the Czech Republic - having a market share of around 68%. This position is further supported by its vertical integration as (1) CEZ's own coal mines cover 68% of its lignite needs; and (2) it has a 32% market share in supply. Mitigating this however, is the fact that CEZ's generation fleet in Czechia is predominantly fixed-cost in nature, with over 75% of its capacity represented by lignite, nuclear and hydro. This makes the company particularly exposed to changes in power prices.

Exhibit 3

CEZ's generation is predominantly fixed-cost
(Output in TWh)



Source: company, Moody's Investors Service

In common with its peers, CEZ has been impacted by the weak power price environment in Europe as Czech power prices are closely linked to German power prices given the interconnections between the two countries. We expect CEZ's EBITDA to further decline in 2017 before stabilizing from 2018 onwards as wholesale power prices have stabilized around €30/MWh.

Ar the same time, CEZ benefits from a low cost generation fleet, which is profitable and allows the company to generate positive free cash flows even in the current low power price environment. The company's generation costs are low partly because its lignite plants, which account for about 43% of output, are mostly located in the vicinity of the mines where the lignite is sourced. The average variable cost of CEZ's lignite plants is around €13/MWh.

Regulated distribution activities support cash flow stability

CEZ's rating is supported by its regulated electricity distribution activities in the Czech Republic whose revenues benefit from a relatively high degree of visibility. Czech distribution activities, which accounted for 30% of group EBITDA in 2016, are in their fourth regulatory period which covers the 2016-18 period. CEZ owns and operates 5 of the 8 distribution grids in the country representing an aggregate Regulated Asset Base (RAB) of CZK89 billion and covering around 62% of total customers. Revenues are underpinned by a well-developed regulatory framework allowing for cost and investment recovery, with a current WACC (nominal, pre-tax) of 7.95%. The group's distribution activities in Romania (Baa3 stable) and Bulgaria (Baa2 stable) are much smaller in scale and provide less earnings predictability due to less stable regulatory environments.

Exhibit 4
CEZ's domestic regulated network activities provide cash flow stability

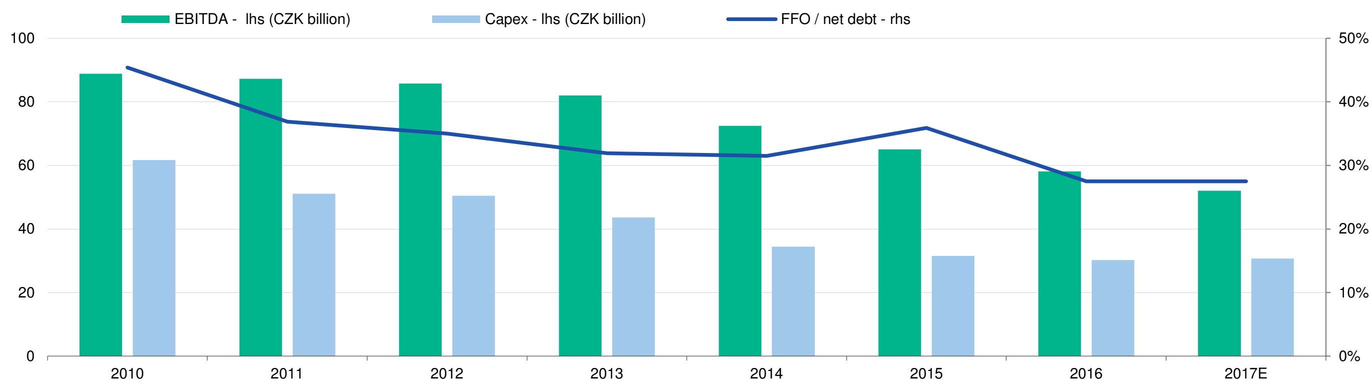
	Czech Republic Electricity Distribution	Bulgaria Electricity Distribution	Romania Electricity Distribution
Regulator / Price Control	ERU / 4th regulatory period	EWRC / 4th regulatory period	ANRE / 3rd regulatory period
Regulated businesses	ČEZ Distribuce, a. s.	CEZ Razpredelenie Bulgaria AD	CEZ Distributie S.A.
Regulatory period	2016-18	2015-18	2014-18
Pre-tax allowed return	7.951% (nominal)	7.04% (nominal)	7.7% (real)
Regulated Asset Base (year-end 2016)	€3,280 million	€277 million	€532 million

Source: company, Moody's Investors Service

Low power prices and potential new investments will keep a lid on credit metrics

Low power prices will lead to a further reduction in operating cash flow in 2017 as hedges roll off, although the impact on credit metrics will be partly mitigated by a reduced capex program of around CZK30-35 billion per annum between 2017 and 2020 following the completion of investments designed to refurbish and upgrade the generation fleet in previous years. Based on wholesale power prices around €30/MWh and a dividend payout ratio towards the top of the company's range of 60-100%, we expect that CEZ will demonstrate FFO/net debt in the mid to high twenties in percentage terms in the medium term in the absence of additional investments that have not been identified yet.

Exhibit 5
We expect credit metrics to stabilize around current levels as capex moderates



Source: company, Moody's Investors Service

We note CEZ's strategy to strengthen its position in central Europe by investing an additional CZK50 to 60 billion by 2020 into renewables, decentralized solutions, heat sector and distribution, notably, should the opportunities arise. Although this strategy is comparable with that of most of its European peers, we believe execution risk is particulary elevated for CEZ as it may expose the company to new businesses and geographies, as evidenced by the acquisition of 98 MW of wind capacity in Germany at the end of 2016.

Development of new nuclear would be credit negative

CEZ has been preparing the development of two new nuclear units, no. 3 and 4, at its existing site in Temelin in Czechia. 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 Baa1 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 government provides rating uplift

In accordance with our rating methodology for Government-Related Issuers (GRIs), CEZ's Baa1 rating incorporates one notch of uplift from its standalone credit quality or Baseline Credit Assessment (BCA) of baa2 based on our estimate of strong support from the Czech government (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 balances (1) the fact that CEZ generates the majority of its earnings in Czechia and is among the largest companies in the country, as a result of which there is a significant correlation between its credit quality and the overall macroeconomic development in the region; with (2) an exposure to developments in the German power market which influence heavily Czech power prices.

CEZ presents a relatively high exposure to decarbonisation risks

The EU has committed to reduce greenhouse gas emissions by 40% from 1990 levels and to increase the contribution of renewables to energy demand to 27% by 2030. These targets, agreed in 2014, formed the basis of the EU's Nationally Determined Contributions incorporated into the Paris Agreement, and are designed to significantly decarbonise the region's economies. We believe that unregulated utilities, which account for 40% of EU carbon emissions, will need to deliver a significant share of the reductions, and that this will create a variety of risks and opportunities for individual utilities.

We believe that CEZ has a relatively high exposure to carbon transition risks compared to peers, given its material exposure to centralized and carbon-intensive (lignite) power generation. Despite the company's ambition to become a major European player in renewables, and small investments in consumer technology, CEZ currently has limited exposure to renewables and services.

Liquidity Analysis

CEZ's liquidity is strong, underpinned by CZK18 billion of cash, CZK10 billion of highly liquid financial assets and CZK22 billion of undrawn committed facilities at 31 March 2017. We believe that these sources, together with cash flows underpinned by an expected EBITDA of CZK52 billion in 2017, should be sufficient to meet the company's liquidity needs in the coming 12 months. These primarily include dividends of around CZK18 billion, capex of around CZK30-35 billion and debt maturities of CZK31 billion. We further note the successful sale of CEZ's 7.5% stake in MOL which was finalised in early April. Proceeds from disposal were used for early redemption of convertible bonds in the amount of CZK12.6 billion, originally maturing in August 2017. This transaction reduced the company's short-term debt maturities and decreased its net debt by €418 million.

Corporate Profile

CEZ, a.s. (CEZ, Baa1 stable) is one of the largest electric utility companies in Central and Eastern Europe with 15.7 GW of power generation capacity and more than 7 million customers. The group operates primarily in the Czech Republic (74% of revenues in 2016) as well as in Bulgaria (12%), Romania (6%) and Poland (4%). CEZ's core businesses are (1) power generation, which includes traditional energy and renewables, comprised 44% of group EBITDA in 2016; (2) regulated distribution which contributed 35%, and (3) sales (including supply activities) which contributed 9%. In addition, the group is involved in coal mining and other activities, which complement the core business segments and contributed around 12% to group EBITDA in 2016.

CEZ is approximately 70% owned by the Czech government (A1 stable), whilst the remaining shares are listed on the Prague stock exchange. The company's current market capitalisation is around CZK230 billion (€8.6 billion).

Rating Methodology and Scorecard Factors

CEZ is rated in accordance with the rating methodology for Unregulated Utilities and Unregulated Power Companies, published in October 2014, and Government-Related Issuers, published in October 2014.

Exhibit 6

CEZ, a.s. - Methodology Grid

Unregulated Utilities and Unregulated Power Companies Industry Grid [1][2]	Current 12/31/2016		Moody's 12-18 Month Forward View As of May 2017 [3]	
Factor 1 : Scale (10%)	Measure	Score	Measure	Score
a) Scale (USD Billion)	$25 bn	A	A	A
Factor 2 : Business Profile (40%)				
a) Market Diversification		Ba	Ba	Ba
b) Hedging and Integration Impact on Cash Flow Predictability		Baa	Baa	Baa
c) Market Framework & Positioning		Ba	Ba	Ba
d) Capital Requirements and Operational Performance		A	A	A
e) Business Mix Impact on Cash Flow Predictability		Aa	Aa	Aa
Factor 3 : Financial Policy (10%)				
a) Financial Policy		Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg)	8.1x	A	6.0x - 8.0x	BaA
b) (CFO Pre-W/C) / Net Debt (3 Year Avg)	31.5%	Baa	25% - 30%	Baa
c) RCF / Net Debt (3 Year Avg)	19.0%	Baa	13% - 18%	Baa/Ba
Rating:				
a) Indicated Rating from Grid		Baa1		Baa2
b) Actual Baseline Credit Assessment Assigned				baa2

Government-Related Issuer	Factor
a) Baseline Credit Assessment	baa2
b) Government Local Currency Rating	A1
c) Default Dependence	Moderate
d) Support	Strong
e) Final Rating Outcome	Baa1

Notes: [1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations; [2] As of 12/31/2016; Source: Moody's Financial Metrics™; [3] 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.
Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
CEZ, A.S.	
Outlook	Stable
Senior Unsecured	Baa1
CEZ MH B.V.	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	Baa1

Source: Moody's Investors Service

REPORT NUMBER 1069768

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