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Research Update:

Czech Utility CEZ a.s. Ratings Affirmed; Outlook Stable; SACP Revised To 'bbb' On Deteriorating Credit Metrics

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Overview

- We forecast Czech utility CEZ a.s.' (CEZ) EBITDA from its unregulated activities will continue to decline, which, coupled with a higher-than-expected dividend payout ratio, will lead to weakening credit measures.
- We are therefore revising to 'bbb' from 'bbb+' the stand-alone credit profile of CEZ.
- We are, however, affirming our 'A-' issuer credit rating on CEZ, reflecting our view that the group continues to benefit from a moderately high likelihood of extraordinary support from the Czech government.
- The outlook remains stable.

Rating Action

On Nov. 23, 2017, S&P Global Ratings affirmed its long-term corporate credit rating on Czech utility CEZ a.s. (CEZ) at 'A-'. The outlook remains stable.

At the same time, we affirmed our 'A-' long-term issue rating on CEZ's senior unsecured bonds.

Rationale

The affirmation reflects our view of the continued moderately high likelihood of extraordinary support to CEZ from the Czech government if needed. This mitigates our lower assessment of CEZ's stand-alone credit profile (SACP), which we have revised downward to 'bbb' from 'bbb+', reflecting weakening credit measures.

CEZ has been significantly increasing its dividend payout ratio over the years, reaching around 90% in 2017--against less than 80% in our precedent base case--at the request of its majority shareholder, the Czech government. We have revised our expectations accordingly and now expect the group to post an only slightly positive discretionary cash flow (DCF)-to-debt ratio of 2.1%, on average, in the next two years. This differs from our previous expectations of around 5%, owing to sizable dividend payments and capital expenditures (capex). We expect this level will weaken the group's credit measures and therefore no longer believe that CEZ benefits from stronger credit metrics than entities with similar financial and business profiles.

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Meanwhile, we believe that CEZ has shown only moderate resilience to adverse power price developments over the past five years. Unregulated activities have halved their contribution to the group's EBITDA between 2012 and 2016--now accounting for 65% (86% in 2012)--owing to the vulnerability of its traditional power production segment to declining power prices in the Czech and German electricity markets (which we view as deeply integrated). Consequently, the group's EBITDA margin has gradually deteriorated over the same period and we expect this trend to continue with EBITDA margins hovering around 25% for 2017 and 2018, down from 41% in 2012. Decreasing EBITDA margins, coupled with higher dividends resulted in the deterioration of CEZ's credit metrics, notably our adjusted funds from operation (FFO)-to-debt ratio. We now forecast this ratio will decline to about 25%-26% for the next two years from 30% previously.

CEZ continues to sell a sizable portion of its future production to the Czech power market at a pre-agreed price, which accounted for 81%, 57%, and 26% of its production for 2018, 2019 and 2020, respectively, as of September 2017. To some extent, this hedging strategy has allowed the group to smooth the pressure of adverse electricity price developments on its cash flows, while bolstering their predictability over the past five years. Nevertheless, we believe that the agreed price at which the group is currently selling its production--averaging €30 per megawatt hour (/MWh) between 2018 and 2020--will be significantly below market prices for the same period. Those have recovered from a low level and should remain around their current level of €35/MWh owing to, among others, the recent global increase of coal prices. We therefore envision CEZ to benefit only modestly from the forecast uptick of power prices over the next two years, which will weigh on its financial metrics over this period.

That said, CEZ benefits from an unrivalled position in the Czech Republic as a vertically-integrated utility with almost 70% and 30% of domestic market shares for its generation and supply segments, respectively. In particular, the group benefits from its diverse and relatively fuel and emission-efficient generation fleet along the load curve, spread across lignite and hard coal (52% of total generation), nuclear assets power (39%), hydro and renewables (6%), and combined cycle gas turbines (3%).

In addition, CEZ is the sole Czech utility company able to generate power from nuclear sources and its nuclear assets comprise the relatively new Czech-based Temelin and Dukovany nuclear plants. In this respect, we believe that pressures on the group's operating performance stemming from past-unplanned nuclear outages over the last three years--due to prolonged weld checks and license renewals--have abated. We now expect a gradual recovery of nuclear generation volumes, reaching their 2014 level by 2019. This will further support the group's operating performance in reducing the use of less cost efficient lignite and hard coal sources as a substitute of nuclear sources for power generation. We understand that talks are ongoing between CEZ and the government-run Standing Committee for Nuclear Energy regarding the development of a new nuclear project in Czech Republic. Owing to the significant uncertainty surrounding the outcome of such talks, we have not incorporated it in our ratings. We nonetheless understand that the decision regarding the selection of the financial model for this project will be announced in 2018. The final investment decision and potential commencement of construction is expected to take place around 2028.

CEZ derives the rest of its EBITDA (35% in 2016) from its regulated activities, predominantly power distribution networks in Czech Republic. We assess the Czech regulatory framework as strong, supported by an independent regulator with a relatively established track record, sufficient clarity on key inputs, good predictability under the three yearly regulatory period (2016-2018), and fairly supportive of new investments. This has contributed to enhanced stability and predictability of earnings that CEZ derives from its regulated activities and will support the group's business risk profile overall. We expect CEZ to continue to increase its EBITDA from regulated activities in the coming years on the back of increased capex. This will lead to a gradual increase in the company's regulated asset base. We understand that the current regulatory period may be extended by two years to 2020 as proposed by the national regulator through a public consultation process in August 2017, with a final decision expected ahead of year-end. Albeit not ruling out the likelihood of such extension, we have not yet factored it in our base case.

In our base case, we assume:
- Moderate growth in electricity consumption in the Czech Republic;
- Czech power prices and carbon dioxide (CO_2) assumptions continue to be linked to the German power market. Relatively stable forward power prices, remaining above €35/MWh for the next two-three years. Actual power prices are applied to hedged output;
- CO_2 allowance price expected not to differ significantly from their current level of 7.40 (euro/megaton);
- Current regulatory period to end in 2018;
- Profit margins strengthening in the long run, due to CEZ's increasing ability to produce electricity from more cost-efficient sources (nuclear and renewables) coupled with a prolonged recovery of power prices at current level of around €35 per MWh;
- Due to lack of investment projects, we forecast slightly positive discretionary cash flows, which are used for debt repayment;
- Capex to remain at about Czech koruna (CZK) 33 billion yearly;
- No material mergers and acquisitions transactions; and
- Dividend payout ratio not to exceed 100%.

We consider CEZ to be a government-related entity, and believe there is a moderately high likelihood that the Czech government would provide extraordinary support to CEZ in the event of financial distress. Our assessment is not affected by the current political uncertainty surrounding the formation of the next Czech government following the recent parliamentary elections in October 2017.

Our assessment is based on CEZ's:

- 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 around 70% of the domestic power output--sufficient to cover domestic consumption requirements--and distributes more than 65% of electricity in the Czech Republic; and
- Strong link with the Czech government, 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. We anticipate that the state will retain its strategic control over CEZ and will remain a supportive shareholder by avoiding negative interventions, such as significantly raising the dividend payout ratio or implementing windfall taxes on power companies.

Liquidity

We view CEZ's liquidity position as adequate based on our expectation that available liquidity resources will cover expected cash outflows by more than 1.2x in the next 12 months. We also forecast that liquidity sources will cover uses even if EBITDA declines by 15%.

We believe that CEZ has a solid relationship with its banks, a high standing in the credit markets, and prudent risk management. We also understand that CEZ's credit facilities are free from onerous financial covenants. The company has various committed undrawn lines maturing between 2018 and 2020. Reflecting significant cash and credit facilities, the group should have the ability to absorb, without refinancing, high impact, low probability events.

As of Sept. 30, 2017, CEZ had the following liquidity sources:

- Unrestricted cash and securities of CZK20.8 billion, according to management data.
- Available headroom of about CZK16.8 billion under various committed back-up facilities maturing after 12 months.
- FFO of about CZK49 billion.

As of Sept. 30, 2017, CEZ had the following liquidity uses:

- Debt maturities of about CZK21.5 billion over the next 12 months.
- Annual capex of about CZK31 billion in the next 12 months as per the company's guidance.
- Dividend payout ratio of 90%; about CZK17 billion in the next 12 months.

Outlook

The stable outlook reflects S&P Global Ratings' view that CEZ will be able to maintain its strong market position in the Czech Republic and maintain adequate credit metrics, despite earnings pressure in the current weak market environment. We consider a ratio of S&P Global Ratings-adjusted FFO to debt above 25% and positive discretionary cash flows as being commensurate with CEZ's current SACP of 'bbb'. Our stable outlook also reflects our unchanged view of a moderately high likelihood of extraordinary support from the Czech Republic.

Downside scenario

We could lower the ratings on CEZ if its SACP falls by one notch or more. This could stem from:

- Much weaker power prices and electricity generation spreads than we currently anticipate or free CO2 allowances unexpectedly not being granted by the Czech government, eventually leading to an adjusted FFO-to-debt ratio for CEZ falling below 25% for a prolonged period.
- Signs of increased political risk--for example, policies that aim to extract cash from power utilities in the Czech Republic, either through increased dividends or windfall taxes--having adverse implications for CEZ's financial metrics and leading for instance to a negative DCF-to-debt ratio.

Increased political uncertainty and evidence of negative government intervention could also undermine our current assessment of the likelihood of extraordinary support to CEZ from the Czech government, which could prompt us to lower the ratings on CEZ.

We could also lower the ratings on CEZ if the local currency rating on the Czech Republic were lowered.

Upside scenario

We see upside potential for the ratings as currently limited as it would require a substantial improvement in CEZ's SACP by two notches, a higher assessment of the likelihood of extraordinary support to CEZ from the Czech government, or an upgrade of the sovereign rating.

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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)

- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Sovereign rating: AA/Stable/A-1+
- Likelihood of government support: Moderately high (+2 notches)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Czech Republic 'AA-/A-1+' Foreign Currency And 'AA/A-1+' Local Currency Ratings Affirmed; Outlook Stable, July 21, 2017

Ratings List

Ratings Affirmed

CEZ a.s.	
Corporate Credit Rating	A-/Stable/--
Senior Unsecured	A-

Additional Contact:
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.