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Research Update:

Czech Utility Company CEZ a.s. 'A-' Rating Affirmed; Outlook Stable

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Overview

- We expect CEZ's credit metrics will deteriorate in 2018, with S&P Global Ratings-adjusted funds from operations (FFO) to debt of 20%-23%, due to several one-off events and the delayed fallout from historically low power prices.
- However, we also expect CEZ will take advantage of the more favorable power price environment from 2019 onward as historical hedge positions expire, with FFO to debt above 25% for 2019-2020, while earnings from regulated activities and contained capital expenditure will provide increased cash flow generation flexibility.
- Our ratings and outlook do not capture the material event risk that CEZ would face if, following a governmental decision, the company were to accommodate the construction of a new nuclear reactor, which could also entail the reorganization of the company.
- We are affirming our 'A-' issuer credit rating on CEZ.
- The stable outlook reflects our expectations of a rebound in credit metrics (with FFO to debt averaging above 25% for 2019-2020), as well as a moderately high likelihood of extraordinary support from the Czech government.

Rating Action

On Nov. 23, 2018, S&P Global Ratings affirmed its 'A-' long-term issuer credit rating on Czech utility CEZ a.s. 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 gradual improvement in financial headroom for CEZ from 2019 onward, supported by more favorable power prices. It also reflects our continued assessment of a moderately high likelihood of extraordinary support to CEZ from the Czech government, if needed. We are affirming the rating despite our anticipation of weak 2018 results and credit metrics below our expectations for the current ratings, with funds from operations (FFO) to debt falling to 20%-23%, below the 25% that we would view as commensurate for the current ratings. We also note that the company structure may change significantly in the coming quarters, depending on a governmental decision on the role CEZ will have to play in the Czech Republic's future energy policy. At this stage, the probability, timing, scope, and credit implications of such a restructuring remain very unclear and are not part of our base-case scenario.

We expect the positive power price developments over the past two years will result in a gradual improvement of the company's operating performance. As part of its hedging strategy, CEZ sells a sizable portion of its future power production to the Czech power market at a pre-agreed price. This means that positions hedged at lower prices in the past will gradually reach maturity and the company will take advantage of the past price increases on future hedges. We understand that pre-sold volumes accounted for 84% at a pre-agreed price of €35.8 per megawatt hour (/MWh) for 2019, 56% (€38.8/MWh) for 2020, and 25% (€39.1/MWh) for 2021. This is higher than the approximate €31/MWh price in 2017-2018. We therefore estimate the company's sensitivity to adverse power prices or generated output to be relatively moderate.

In addition, the predominantly low-cost structure of CEZ's power generation fleet--with more than 80% of its generated output sourced from nuclear and recently redesigned lignite plants--also allows the company to benefit from increased power prices. CEZ's generation fleet currently operates with a low fuel cost base; nuclear fuel costs (including an approximate €2/MWh contribution to the state's nuclear account) amount to approximately €7/MWh, while lignite costs amount to approximately €26-€27/MWh with a current CO_2 price of about €20/ton. The relatively low variable cost on the latter is partly the result of the internal sourcing of 71% of the company's needs, along with the geographic proximity of the mines from which the company sources its lignite. We understand that, unlike some other EU countries, the Czech Republic has an energy policy that is relatively supportive of nuclear power and coal, owing to the relatively limited natural potential for wind and solar generation in the country.

We believe that cash flow visibility is further bolstered by the material contribution of regulated activities (35% in 2017)--predominantly power distribution networks in Czech Republic--to the company's earnings. 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 five-year regulatory period (2016-2020), and a 7.951% allowed nominal return. We also consider the regulator to be fairly supportive of new investments. This has helped enhance the stability and predictability of earnings that CEZ derives from its regulated activities, and will support the company's overall business risk profile. As power prices recover and EBITDA from power generation increases, the relative contribution from network activities will reduce. We see a normalized level of contribution from network activities under the supportive Czech regulatory framework of 25%-30%. As such, we benchmark CEZ's credit metrics with the standard volatility table.

We also believe that contained capital expenditure (capex) intensity will support cash flow generation flexibility over the coming two years. This is because CEZ has invested heavily in recent years in the renovation and upgrade of its coal generation fleet, and capex outlays will now be predominantly geared toward maintenance expenditures, averaging Czech koruna (CZK) 32 billion-CZK33 billion per year over 2018-2022.

That said, we believe that CEZ's ability to reduce its debt will be hindered by continuous, sizable dividend distributions at the request of its majority shareholder, the Czech government. We expect these distributions will average about CZK15 billion per year over 2018-2020, and payout ratios will remain relatively high (90%-100%) over this period.

As part of its future national energy policy, the Czech government is seeking a funding solution for a potentially large investment, with a preliminary estimate of approximately CZK150 billion, for the construction of a new nuclear reactor in the country after CEZ's Dukovany nuclear power plant ceases operations in 2035. At this stage, it remains unclear whether the government would absorb the potentially large capex related to the new nuclear project, or if this cost would fall on CEZ's balance sheet. We understand that the government's decision was initially scheduled for the end of 2018, but we do not rule out its postponement to 2019. The construction of the nuclear plant would only start in 2028 at the earliest, with commissioning expected to start in 2035, absent potential delays that could affect such a complex construction. Therefore, owing to the relatively long horizon for this complex project, the government may instead decide to delay its decision and extend the life of the Dukovany power plant by an additional five to 10 years. Czech Prime Minister Andrej Babis has publicly stated the government's preference for the company to fund this project, with the state supporting the project by acting as a guarantor. We think the minority shareholders of CEZ (with a 30% stake in the group) would challenge such a proposition because it would likely dramatically change the group's capital structure and risk profile.

One of several options that the government is currently considering is a split of the company's activities between conventional power generation activities and mining on the one hand, and new energies (renewables), supply, and network activities on the other. Our ratings do not capture the material event risk that may emerge from this reorganization, since the timing and eventual structure of such a transaction remain highly uncertain. As far as we understand, there are relatively few restrictions regarding the CEZ's restructuring in the company's current bond documentation. The "change of control" clause, included in the current bond documentation of CEZ's €8 billion Euro Medium Term Note program, stipulates that a change of control event--granting noteholders the right for an early redemption of their notes--would only come into effect if the Czech Republic's share of issued capital or voting rights were to fall below 50%. Early redemption would also require either the downgrade of CEZ to a non-investment-grade credit rating, or the withdrawal of the rating, in the 180 days following the public announcement of this drop in shares. As of the end of 2017, the group's reported debt amounted to CZK152.2 billion. Bond issuances accounted for

CZK116 billion of this figure.

Our base case assumes:

- Moderate growth in electricity consumption in the Czech Republic.
- Czech power prices to continue to be linked to the German power market.
- Relatively stable future power prices, remaining above €45/MWh, as indicated by the market exchange for Central European power generation. Actual power prices are not applied to hedged output.
- Hedged output: 84% at an average selling price of €35.8/MWh for 2019, 56% (€38.8/MWh) for 2020, and 25% (€39.1/MWh) for 2021.
- CO_2 allowance price to remain at about €20/ton.
- Capex to remain at about CZK32 billion-CZK33 billion per year in 2018-2021 (about CZK30 billion per year with an uptick to CZK37 billion in 2019 to finance the upgrade of the Melnik coal-fired power plant).
- No material mergers and acquisitions transactions or any specific transformation of the company, with no specific outcome for the new nuclear project.
- Dividend payout ratio remaining at or below 100%.
- Czech koruna-to-euro foreign exchange to remain stable at about 26x.

Based on these assumptions, we arrive at the following credit measures for 2019-2020:

- Profit margin to gradually strengthen before stabilizing at about 29%-30%, owing to the delayed impact of increased power prices on the German and Czech power markets and CEZ's ability to produce electricity from relatively cost-efficient sources;
- FFO to debt of about 25%-27% and about 28%-30% for 2019 and 2020, respectively; and
- Positive cash flows on aggregate due to contained capex, a lack of significant investment projects, and despite sizable dividend payments.

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.

We base our assessment on CEZ's:

- Important role for the Czech government as both a provider of an essential service and as a key player in the implementation of state energy policies. The company produces about 72% of 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.

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

CEZ currently has a relatively lumpy debt maturity profile with approximately €750 million and €950 million coming due in 2020 and 2021, respectively, as part of previous Eurobond issuances.

We expect principal liquidity sources over the 12 months from Sept. 30, 2018 will include:

- Unrestricted cash and securities of CZK14.5 billion, according to management data;
- Available headroom of about CZK11 billion under various committed back-up facilities maturing after 12 months, to which we add the proceeds of its €500 million (CZK12.9 billion) bond issuance in mid-November 2018; and
- Cash FFO of about CZK47 billion.

We expect principal liquidity uses over the same period will include:

- Debt maturities of about CZK19.2 billion;
- Annual capex of about CZK37 billion for 2019, as per the company's guidance;
- Dividend payout ratio of 100% in 2019 of about CZK 11.9 billion; and
- Acquisitions of about CZK0.9 billion in 2019.

Outlook

Our stable outlook on CEZ a.s. reflects our view that the company will be able to maintain its strong market position in the Czech Republic and maintain adequate credit metrics, as earnings pressure will likely abate in the foreseeable future on the back of improving power prices. We consider a ratio of S&P Global Ratings-adjusted FFO to debt above 25% and positive discretionary cash flow (DCF) as being commensurate with CEZ's current stand-alone credit profile (SACP) of 'bbb'.

Our stable outlook also reflects our unchanged view of a moderately high likelihood of extraordinary support from the Czech Republic. At this stage, our base case does not factor in the future decision of the Czech government regarding the financing of the future new nuclear project. Once this decision becomes public, we could place the ratings on CreditWatch to assess the decision's implications for CEZ's future business perimeter and balance-sheet quality.

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 coal spreads than we currently anticipate, or generated output markedly reducing due to unplanned outages, eventually leading to an adjusted FFO-to-debt ratio 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 example, to a negative DCF-to-debt ratio. This would also stem from the Czech government's decision to use CEZ to fund the new nuclear project.

Increased political uncertainty and evidence of detrimental 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 downgrade CEZ.

We could also downgrade CEZ if we were to lower the local currency rating on the Czech Republic.

Upside scenario

Absent a potential favorable outcome regarding the government's reorganization of the company--not incorporated in our base case at this stage--we currently see the upside potential for the ratings as limited. This would require either a substantial, two-notch upward revision of CEZ's SACP, a higher assessment of the likelihood of extraordinary support to CEZ from the Czech government, or an upgrade of the sovereign ratings on the Czech Republic.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/--

Business risk: Strong
- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk:
- 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, March 28, 2018
- 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: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Ratings List

Ratings Affirmed

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

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 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.