FitchRatings

Fitch Affirms Poland's Tauron at 'BBB'; Rates New Hybrids 'BB+'

Fitch Ratings-Milan/London/Warsaw-17 April 2019: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB' with Stable Outlooks. Fitch has also assigned Tauron's new PLN400 million (EUR94 million) hybrid bonds issued on 29 March 2019, under the PLN400 million hybrid bonds programme with Bank Gospodarstwa Krajowego (BGK, A-/Stable) from 2017, a local-currency rating of 'BB+' and a national rating of 'BBB+(pol)'. A full list of rating actions is available at the end of this commentary.

The affirmation of the IDRs reflects the dominant share of regulated power distribution in Tauron's EBITDA. This will be supported by a new quasi-regulated EBITDA stream from the capacity market from 2021, Tauron's plans to reduce capex following the expected start of operations of new generation blocks, and reduced financial pressure on credit metrics from 2021.

We forecast Tauron's funds from operations (FFO) adjusted net leverage will temporarily exceed the negative rating guidance of 3.5x in 2019 and 2020, mostly due to a peak in capex spending on construction of the new generation blocks. In the long term, the key constraint for the rating is the dominance of coal in Tauron's fuel mix, resulting in exposure to carbon dioxide costs, which are currently reflected in wholesale electricity prices in Poland.

The new hybrid bonds were subscribed by Polish state-owned development bank BGK and qualify for 50% equity credit. Fitch rated the hybrid bond programme with BGK in 2017, which with the PLN400 million hybrid bonds issue became fully utilised.

KEY RATING DRIVERS

High Share of Regulated Business: The ratings reflect the high share of regulated and fairly stable distribution business in Tauron's EBITDA (75% in 2018). We expect it to decrease to about 65% from 2021 due to an additional cash flow stream in generation from the capacity market and start of operations of the new power generation units, which Tauron is building, by end-2019, but also from the mining division following expansionary capex.

Capacity Payments: Tauron has won capacity payments in the first three capacity market auctions held in Poland in November and December 2018. The company will receive around PLN0.6 billion a year of additional revenue from capacity payments in 2021-2023, accounting for around 15% of EBITDA, which we treat as quasi-regulated.

Fitch deems that the implementation of a capacity payments mechanism in Poland, approved by the European Commission in February 2018, will support the investments and profitability of electricity generators, including Tauron. It should be a predictable source of EBITDA from electricity generation and can provide additional debt capacity for the current ratings.

Capex to Decrease from 2021: Tauron has been constructing new power generation units in Jaworzno (0.91GW, coal-fired, fully consolidated) as well as in Stalowa Wola (0.45GW, combined-cycle gas turbine), which is a joint project with Polskie Gornictwo Naftowe i Gazownictwo S.A. (PGNiG, BBB-/Stable) and consolidated at equity. We expect Tauron's capex to peak in 2019, when the Jaworzno III power generation unit should come on stream (with the first full year of operations being 2020). Tauron's capex should decrease to below PLN4.0 billion from 2021.

At the same time, Tauron's capex will become more focused on distribution, the share of which should increase by up to about 75% by 2022 from around 50% in the past few years. High capex in the distribution segment is positive for Tauron's credit profile as it increases the regulatory asset base and helps to keep a large contribution from this business.

Higher CO_2 Prices: We expect that Tauron's coal-fired generation business will come only under limited pressure from higher CO_2 prices. This is due to the low interconnectivity of the Polish market and domination of coal-fired generation in the country's fuel mix. Consequently, higher generation costs affect most of the market and are reflected in rising wholesale electricity prices. We expect this pass-through effect to gradually weaken, but only in the long term. Wholesale electricity prices have been increasing even in the typically lower-price markets, such as in Germany and in Scandinavia, hence imports, even if technically possible, would be less competitive.

Frozen Supply Tariffs: Higher wholesale electricity prices create pressure on retail electricity prices, which increase largely in parallel. To avoid this, in Poland the government has lowered excise duty and the so-called interim payment (one of the levies) imposed on end-customers as well as set up a dedicated fund to compensate electricity retailers for higher costs of electricity purchases, so that retail prices in 2019 will remain unchanged from 1H18 levels. The payments coming from this fund should preserve the 2019 results of Tauron's supply division.

However, due to the lack of executive regulation to the bill approved by the Polish parliament in December 2018, electricity retailers in Poland, including Tauron, have not yet received compensation for frozen supply tariffs. These are expected to arrive later this year upon completion of negotiations with the European Commission with respect to executive regulations, but for now they have created a deficit in the supply business of about PLN200 million at end-2018.

Fitch assumes that Tauron will be fully reimbursed in the course of 2019 for the deficit between lowered retail price and higher purchase costs of electricity incurred in 2H18 and 2019. The reimbursement mechanism leaves uncertainty for 2020 and beyond with respect to its continuation or suspension. Inability to pass through higher electricity purchase costs without any form of compensation would be credit-negative for Tauron.

Leverage May Temporarily Exceed Guidelines: We anticipate that Fitch-calculated FFO adjusted net leverage will peak in 2019 and 2020 at the planned start of operations of the new power generation units in Jaworzno and Stalowa Wola. We forecast that FFO adjusted net leverage will amount to around 3.7x over 2019-2020 and return to below 3.5x from 2021 thanks mostly to the inception of capacity payments, contribution from the new power plants and lower capex. This leaves no rating headroom under the current ratings.

Rated on a Standalone Basis: Tauron is 30%-owned and effectively controlled by the Polish state (A-/Stable). Based on Fitch's Government-Related Entities (GRE) Rating Criteria, we assess status, ownership and control links as strong, support record and expectations as weak, socio-political impact of Tauron's hypothetical default as moderate, but the financial implications of such a hypothetical default as weak. Consequently, we do not apply any notching-up for links with the Polish state and Tauron is rated on a standalone basis.

New Hybrid Issued: Tauron's March 2019 hybrid bonds issue of PLN400 million was fully subscribed by BGK under the hybrid bonds programme rated by Fitch in December 2017. The bonds are rated two notches below Tauron's Local-Currency Long-Term IDR (i.e. at 'BB+') given their deep subordination and, consequently, the lower recovery prospects in a liquidation or bankruptcy scenario relative to the senior obligations.

The securities qualify for 50% equity credit as they meet Fitch's criteria with regards to deep subordination, a remaining effective maturity of at least five years, full discretion to defer coupons for at least five years and limited events of default. Equity credit is limited to 50% given the cumulative interest coupon, a feature considered more debt-like in nature. Fitch will apply a 50% equity credit to the new hybrids until March 2026, which is five years prior to the final maturity of March 2031 (which is also the effective maturity considered by Fitch).

DERIVATION SUMMARY

Tauron's close peer group includes the three other electricity-focused integrated utilities in Poland, which are PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB/Stable).

Tauron's and Energa's business profiles benefit from the large share of regulated distribution in EBITDA, which provides good cash-flow visibility at times when another key segment, conventional power generation, is under pressure.

PGE is the largest company and has the lowest leverage in the peer group. It derives most of EBITDA from electricity generation and has a high share of lignite in the generation fuel mix, which provides the company with cost advantage over hard coal-fired peers, such as Tauron and ENEA. Rising CO2 prices could diminish this cost advantage, given the higher carbon footprint of lignite than hard coal.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time high exposure to hard coal-fired generation and coal mining. This is reflected in Fitch's maximum leverage sensitivity for 'BBB' ratings of 3.0x for ENEA and 3.5x for Tauron and Energa.

All four Polish integrated utilities have limited rating headroom, particularly Tauron and ENEA, due to a projected increase in leverage driven by large capex and changing market conditions.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Wholesale electricity prices at PLN225 per MWh (megawatt hour), hard coal prices at PLN11 per GJ (gigajoule), prices of CO2 allowances of EUR20 per tonne (all on an average, annual basis until 2023);
- Pass-through of CO2 prices to wholesale electricity prices in the Polish market, meaning that if CO2 prices rose above the assumed levels they would be reflected in higher wholesale electricity prices;
- Increased electricity generation volumes from 2020, due to commissioning of a new coal-fired block in Jaworzno, with participation of a PFR-managed fund as a minority equity investor at PLN880 million, and a new gas-fired block in Stalowa Wola in joint-venture with PGNiG;
- Annual revenue from capacity payments at PLN0.6 billion over 2021-2023;
- Weighted-average cost of capital in the distribution segment flat at 6%;
- Capex and acquisitions at PLN21 billion over 2019-2023;
- Receipt of compensation for frozen supply tariffs of about PLN200 million in 2019 related to 2H18 and 2019; no further deficit from 2020;
- Continuation of a zero-dividend policy over 2020-2023.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

Rating upside for Tauron is limited due to the company's business profile and projected increase in leverage due to capex. However, developments that may, individually or collectively, lead to positive rating action include:

- Continued focus on the distribution business in capex and overall strategy, together with FFO adjusted net leverage below 2.5x on a sustained basis, supported by management's consistent leverage target;
- A more diversified fuel generation mix and lower carbon dioxide emissions per MWh, which together with continued efficiency improvements, would result in a stronger business profile.

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 3.5x and FFO fixed-charge cover below 5x on a sustained basis, for example, due to higher capex or reinstatement of dividends from 2020;
- Weaker EBITDA or working capital outflows, for example due to non-receipt of compensation for frozen electricity supply tariffs, prolonged tariff deficit in the supply business, or persistent underperformance of the mining division;
- Business expansion beyond the ongoing projects in coal-fired electricity generation, coal mining or another form of weakening of Tauron's business profile.

LIQUIDITY

Adequate Liquidity: At end-2018, Tauron had PLN659 million of Fitch-defined readily available cash and PLN4.4 billion of committed funding against short-term debt of PLN2.5 billion and Fitch-expected negative free cash flow in the next 12 months of PLN1.8 billion.

Since beginning of the year, Tauron has taken a new PLN730 million loan from BGK and issued the PLN400 million hybrid bonds purchased by BGK. We anticipate that Tauron has sufficient liquidity for the whole 2019, but due to capex-driven negative free cash flow by 2021 we expect Tauron to take on some new debt by 2020.

We do not expect any material consequences from the breach of the 3.0x net debt to EBITDA covenant embedded in the TPEA1119 series of the bonds maturing in November 2019. This is because the breach would constitute an event of default only if accelerated by a super majority of 2/3 at the bondholders' meeting, which we deem as unlikely taking into account agreements from 2016 between Tauron and a blocking majority of 41.93% of bondholders. Tauron has sufficient funds to immediately redeem the bonds. Some other debt agreements of the company have a net debt to EBITDA covenant at a more comfortable level of below 3.5x, which additionally includes 100% equity credit for hybrid securities, and which is met in our rating case.

FULL LIST OF RATING ACTIONS

TAURON Polska Energia S.A.
-- Long-Term Foreign- and Local-Currency IDRs affirmed at 'BBB'; Stable Outlook
-- Short-Term Foreign- and Local-Currency IDRs affirmed at 'F3'
-- National Long-Term Rating affirmed at 'A+(pol)'; Stable Outlook
-- Foreign-currency senior unsecured rating of EUR500 million Eurobonds affirmed at 'BBB'
-- National senior unsecured rating affirmed at 'A+(pol)'
-- EUR190 million hybrid bonds (EIB) affirmed at 'BB+'
-- PLN750 million hybrid bonds (EIB) affirmed at 'BB+'
-- PLN400 million hybrid bond programme (BGK) affirmed at 'BB+'
-- PLN400 million hybrid bond programme (BGK) national rating affirmed at 'BBB+(pol)'
-- PLN400 million hybrid bonds (BGK), issued on 29 March 2019, assigned a rating of 'BB+'
-- PLN400 million hybrid bonds (BGK), issued on 29 March 2019, assigned a national rating of 'BBB+(pol)'

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Summary of Financial Statement Adjustments - Fitch-adjusted debt calculation at end-2018 included the PLN444 million guarantee for the Stalowa Wola gas-fired power plant joint venture. Fifty percent equity credit was allocated to outstanding hybrid bonds.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.
Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub. 09 Nov 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Government-Related Entities Rating Criteria (pub. 29 Mar 2019)
National Scale Ratings Criteria (pub. 18 Jul 2018)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

SOLICITATION STATUS

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