TAURON Polska Energia S.A. (/gws/en/esp/issr/89032866)

FitchRatings

Fitch Rates Tauron's EUR500m Eurobonds 'BBB'

Fitch Ratings-Warsaw/London-05 July 2017: Fitch Ratings has assigned TAURON Polska Energia S.A.'s (Tauron; BBB/Stable) EUR500 million 10-year Eurobonds a final foreign-currency senior unsecured rating of 'BBB'. The bonds are rated in line with Tauron's Long-Term Issuer Default Rating of 'BBB'. They represent unconditional, senior, unsecured obligations of the company. A full list of ratings is available at the end of this commentary.

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 (72% in 2016). This contributes to cash flow predictability at a time when conventional power generation, a key segment, is under pressure from a challenging operating environment and limited fuel mix diversification with a high reliance on coal. Fitch expects the share of distribution at about 65% of EBITDA in 2017-2018, and to slightly decrease in 2019 when the Jaworzno III 910 MW coal-fired power plant comes on stream to boost the performance of the weak generation segment.

Distribution Dominates Capex: Despite allocating fairly high capex for conventional power generation by 2020, distribution continues to dominate Tauron's capex plan (53% of 2016-2020 capex), followed by generation (37%) and coal mining (7%).

Strategy Drives Slower Leverage Increase: One of the key elements of Tauron's strategy update in September 2016 is the support of the financial profile through capex reduction by 11% to about PLN18 billion between 2016 and 2020 (including the cancellation of the PLN1.5 billion gas-fired power plant project in Lagisza), cost reductions and asset optimisation.

A key objective is to maintain leverage below the net debt/EBITDA covenant of 3.5x. Management said that the forecasts prepared for the strategy update indicate that no dividends will be paid until 2019. There were no dividend payments in 2016, compared with a PLN263 million dividend paid in 2015. We assume no dividends until 2019.

Limited Headroom: Fitch views the capex programme as still significant despite the reduction in the strategy update. We project funds from operations (FFO)-adjusted net leverage to increase to about 3.4x in 2017-2018 from 3.1x in 2016, close to the maximum 3.5x for the ratings. As a result, Tauron has limited room for underperformance or additional capex or acquisitions.

Financial Flexibility: In our view, Tauron retains some flexibility to reduce capex or implement other measures should cash flows be below expectations. For instance, it plans to sell to an external investor up to a 50% stake in the Jaworzno III project and has recently signed the memorandum of understanding with two funds managed by Polish Development Fund PFR regarding a PLN880 million investment in the project. Capex in the distribution segment could also be deferred.

Rated on a Standalone Basis: Tauron is 30.06% owned and effectively controlled by the Polish state (A-/Stable). However, Fitch rates it on a standalone basis because we assess legal, operational and strategic links with the state as moderate based on our Parent and Subsidiary Rating Linkage criteria. In our view, the links have had an incrementally stronger impact on the company under the new government since November 2015. Examples include the plan for no dividends until 2019.

Capacity Market Beneficial: In our view, the Polish government's plans to introduce a capacity market are crucial in allowing coal power plants under construction, such as the Jaworzno III plant, to be profitable in the long term. We do not include any cash inflows related to the contemplated capacity market in our rating case forecast until 2020.

DERIVATION SUMMARY

Tauron's and Energa S.A.'s (BBB/Stable) 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. Two other Polish utilities, PGE Polska Grupa Energetyczna S.A. (BBB+/Stable), and ENEA S.A. (BBB/Stable) have a lower share of regulated distribution than Tauron and Energa.
All four Polish integrated utilities have limited headroom under their negative rating guidelines due to a projected increase in leverage in 2017-2019 driven by large capex.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- Weighted average cost of capital in the distribution segment reduced to 5.7% in 2016 from 7.2% in 2015 (and 6.8% when

applying the one-off haircut applied by the regulator), before gradually increasing to around 6% in 2020;
- 5% haircut reducing return on the distribution's regulated asset base incorporated from 2018;
- Wholesale baseload power prices falling to about PLN155 per MWh by 2020;
- Commencement of Jaworzno hard coal power block (0.9GW) and Stalowa Wola CCGT (50% of 0.4GW) in 2019-2020;
- Capex of PLN18 billion for 2016-2020;
- No dividends until 2019.

RATING SENSITIVITIES

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:
- 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 more conservative leverage target.
- A more diversified fuel generation mix and lower CO_2 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 full implementation of capex and weaker-than-expected operating cash flows;
- Acquisitions of stakes in coal mines or other form of support for state-owned mining companies under financial pressure leading to net leverage above 3.5x or substantially worsening Tauron's business profile;
- Failure to maintain adequate liquidity;
- A substantial tax payment arising from an increase in the nominal value of Tauron's shares. This is a cash flow and operating environment risk for Tauron and other Polish state-controlled utilities as the government contemplates an increase of the nominal value of their shares. Such an increase would be subject to approval at the shareholders meeting. This tax payment is not included in our assumptions for the rating case. Fitch treats this as event risk and a potential corporate governance issue.

LIQUIDITY

Sufficient Liquidity: At end-March 2017 Tauron had PLN88 million of readily available cash and PLN3.4 billion of undrawn committed funding against short-term debt of PLN648 million and Fitch-expected negative free cash flow for 2017 of about PLN2 billion. The EUR500 million (PLN2.1 billion) 10-year Eurobonds issue has boosted the company's liquidity and improved debt maturity profile.
FULL LIST OF RATING ACTIONS

Fitch rates Tauron as follows:
--Long-Term Foreign and Local Currency IDRs at 'BBB'; Outlook Stable;
--Short-Term Foreign and Local Currency IDRs at 'F3';
--Hybrid bonds at 'BB+'.
--National Long-Term Rating at 'A+(pol)'; Outlook Stable;
--National senior unsecured rating at 'A+(pol)'.

Fitch has assigned the following rating:
--Final foreign currency senior unsecured rating of 'BBB' to EUR500 million Eurobonds.

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Date of Relevant Rating Committee: 8 June 2017.

Summary of Financial Statement Adjustments:
Fitch-adjusted debt calculation at end-2016 includes the PLN314.5 million guarantee for the Stalowa Wola gas-fired power plant joint venture.
50% equity credit allocated to hybrid bonds of EUR190 million.
Operating leases are capitalised using a 7x multiple.

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

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Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017) (https://www.fitchratings.com/site/re/895493)
National Scale Ratings Criteria (pub. 07 Mar 2017) (https://www.fitchratings.com/site/re/895106)
Non-Financial Corporates Hybrids Treatment and Notching Criteria (pub. 27 Apr 2017) (https://www.fitchratings.com/site/re/896881)
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016) (https://www.fitchratings.com/site/re/886557)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1026088)
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