FitchRatings

Fitch Revises Tauron's Outlook to Negative; Affirms at 'BBB'

Fitch Ratings-Warsaw/London-27 October 2015: Fitch Ratings has revised TAURON Polska Energia S.A.'s (Tauron) Outlook to Negative from Stable and affirmed its Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB'. A full list of rating actions is at the end of this commentary.

The revision of the Outlook to Negative reflects expected lower WACC in electricity distribution from 2016 and the recently agreed acquisition of part of the assets of a loss-making coal mine KWK Brzeszcze. The negative impact of these two developments is mitigated by an equity increase recently proposed by the government. Our updated projections show funds from operations (FFO) adjusted net leverage increasing to above our negative rating guideline of 3.5x in 2017-2019 on the back of the large capex plan.

The Outlook could be revised back to Stable if the company's large capex plan is reduced to match reduced projected operating cash flows in the next few years. The Outlook revision would also be dependent on an improvement in Tauron's medium-term liquidity position as well as reduced risk of a breach of 3x net debt to EBITDA covenant, which is embedded in some financing arrangements.

KEY RATING DRIVERS
High Share of Regulated Business
The affirmation reflects the high share of the regulated and fairly stable distribution business in Tauron's EBITDA (around 60%). This contributes to cash flow predictability at a time when conventional power generation, another key segment, is under pressure due to a challenging operating environment, low margins and limited generation fuel mix diversification with a high reliance on coal. We expect the share of distribution to remain around 60% in 2016-2017. The share of distribution may slightly decrease in 2018-2019 when new power generation units come on stream to boost the performance of the weak generation segment.

High Projected Leverage
The Negative Outlook reflects our updated projections showing FFO adjusted net leverage increasing to above our negative rating guideline of 3.5x in 2017-2019 (peaking at 3.8x in 2018) on the back of large capex plan, from 2.3x in 2014. Pressure on the net leverage ratio may alleviate from 2019 when new generation units are commissioned, increasing FFO.

Tauron has the highest forecast leverage of the four Fitch-rated Polish utilities (PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), Enea S.A. and Energa S.A. - both rated BBB/Stable).

Financial Covenants Under Pressure
According to our projections, the company's net debt-to-EBITDA, which was 1.9x at end-June 2015, will increase to above 3x in 2016-2019, which is the covenant embedded in some financing arrangements. We assume that Tauron will renegotiate and increase the level of financial covenants in the next few months or considerably adjust its capex plan so as not to breach the covenant. Failure to renegotiate the covenant well ahead of a possible covenant breach may be negative for Tauron's liquidity and the ratings. A covenant breach could cause, through cross-default provisions, all Tauron's debt to become immediately due.

Lowered Remuneration in Distribution
We project that the lower WACC for 2016 will reduce Tauron's EBITDA of the regulated distribution business by PLN240m in 2016 (or 7% of total EBITDA). The regulator has recently reduced WACC for 2016 to 5.28% from 7.2% for 2015 (or from 6.84% when incorporating a 5% reduction of return by the regulator). The WACC reduction is partly due to a decrease in market interest rates.

The negative impact of lower WACC on cash flows is alleviated by a high share of floating rate debt in Tauron's debt structure (77% at end-June 2015), providing some interest rate hedging with regards to WACC changes. We assume that WACC will gradually increase to 5.6% in 2019. From 2018 the regulatory return for distributors could be negatively affected by newly introduced quality elements in the tariff system for 2016-2020. Failure to achieve quality thresholds, for instance with regards to average interruption duration and frequency of distribution services, will reduce returns on the regulatory asset base by up to 15% or up to 2% of regulate revenue.

Rated on Standalone Basis
Tauron is 30.06% owned and effectively controlled by the Polish state (A-/Stable). However, Fitch rates it on a standalone basis and does not factor in rating uplift from state ownership. The company operates on a commercial basis and we assess legal, operational and strategic links with the state as moderate, in line with our Parent and Subsidiary Rating Linkage criteria.

Changes in Management and Brzeszcze Acquisition
We believe that the recent changes in Tauron's management board, ahead of the general elections in Poland held on 25 October, may have been related to the government's plan for Tauron and other state controlled utilities to provide support for the coal mining sector as it faces financial difficulties due to its high employment and high cost base combined with the drop in coal prices. The government's plan includes acquisitions of stakes in some loss-making coal mining companies by utilities and a broader consolidation of the electricity and coal mining sectors in order to support coal mines' financial and liquidity position.

The 25 October elections were won by the main opposition party. Consequently a new government will be created, which may lead to changes in the state's strategy towards the electricity and coal mining sectors.

In early October the supervisory board controlled by the government decided to dismiss three of five members of Tauron's management board, including the CEO, while the two remaining members of the board resigned. Subsequently, after several weeks of negotiations the new management board agreed to purchase part of assets of Brzeszcze coal mine from coal mine restructuring company Spolka Restrukturyzacji Kopaln S.A. (SRK). We believe that the agreed terms are less favourable for Tauron than the previous management board's proposal to SRK, which had assumed the acquisition of Brzeszcze in a JV with partners in order to share the planned capex and risks.

Brzeszcze's Weak Financial Results
Tauron agreed to pay a symbolic PLN1 for part of Brzeszcze's assets. In 2014, Brzeszcze was one of the most loss-making coal mines in Poland. It was transferred to SRK from the largest coal mining group Kompania Weglowa S.A. in early 2015 for gradual liquidation or other restructuring measures. After the acquisition Tauron expects a material improvement in Brzeszcze's EBITDA in 2016-2017 due to cost reduction and large capex on an increase in capacity and coal extraction volumes to 1.8m tonnes from 0.9m tonnes in 2014. Brzeszcze reported negative EBITDA of PLN0.2bn (EUR45m) in 2014. There is a risk that after the acquisition Tauron will have to return state aid covering Brzeszcze's losses which was granted to SRK.

The acquisition of Brzeszcze will increase the vertical integration of Tauron's coal mining and electricity generation segment as the group will cover 50% of its coal needs from its own mines up from 40% before the transaction. Tauron plans to close the acquisition by end-2015.

Planned Equity Increase
The government has recently proposed increasing Tauron's equity by PLN400m in order to support the funding of Tauron's large long-term capex plan as the company's expected operating cash flows in the next few years may not be sufficient to implement the full capex plan. We assume that the proposed PLN400m equity increase by the state will be approved by the general shareholders' meeting on 9 November (80% voting majority is required). The equity increase will be in the form of transfer of the state's 1% stake in state-controlled bank PKO BP S.A. to Tauron. We assume that the company will monetise the stake at PLN400m (i.e. no decrease of PKO BP share price is assumed in

our projections). The equity increase will have a positive but fairly small impact on FFO adjusted net leverage, decreasing it by 0.1x.

Challenging Generation Environment
Fitch expects the generation segment to remain under pressure in 2016-2017 due to low wholesale electricity prices, declining free CO2 allowances, rising prices of CO2 and a rising share of renewables supported by subsidies. The impact of a challenging conventional generation environment is mitigated by Tauron's ongoing savings programme focused on the generation segment. We do not view the structural change in the Polish generation market as rapid and far-reaching as in Germany and highlight that interconnections are also only gradually improving, giving domestic players time to adjust.

Weak Generating Diversification
The ratings are constrained by the group's lack of generation fuel mix diversification (coal-fired plants account for 92% of generation capacity), which is unlikely to change materially before 2018, as well as by the age of the generation fleet, which will result in the decommissioning of 1.5GW of capacity by 2019, out of 5.1GW currently.

Strong Market Position
Tauron is the second-largest utility in Poland by revenue and EBITDA after PGE. With 45TWh of electricity distributed in 2014, it is the largest distributor in Poland and its 5.1GW of installed capacity is second only to PGE.

Large Capex
Tauron plans to invest PLN37bn in 2014-2023, of which PLN18.7bn is planned for 2014-2017. Tauron's 2015-2019 capex plan is allocated mostly to the distribution segment for network upgrades and expansion, and to the generation segment for replacement and expansionary capex. The single largest investment project is the Jaworzno III 910 MW coal-fired power plant (net investment of PLN4.4bn, total project value of PLN6.2bn), the construction of which started in 2H14 and should complete in 2019.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- No major shifts in wholesale electricity prices within the forecast period
- Stable coal prices and around 50% increase in CO2 market price within a five-year rating horizon
- Electricity production volumes to rise from 2019 due to commissioning of the 413MW Lagisza gas-fired power plant and the 910MW Jaworzno III coal-fired power plant
- Stable distribution and sales volumes
- Capex of PLN21bn in 2015-2019
- Lower WACC in the distribution segment from 2016: 5.3% in 2016 and then gradual increasing to 5.6% in 2019
- Acquisition of part of Brzeszcze in line with the preliminary agreement and improvement of Brzeszcze's EBITDA in 2016-2017

RATING SENSITIVITIES
Positive: Rating upside for Tauron is limited due to the company's business profile and projected increase in leverage due to capex. The Outlook could be revised back to Stable if the company's large capex plan is reduced in order to match reduced projected operating cash flows in the next few years. The Outlook revision would also be dependent on improvement in Tauron's medium-term liquidity position as well as reduced risk of a breach of 3x net debt to EBITDA covenant.

Negative: Future developments that could lead to negative rating action include:
- Projected FFO adjusted net leverage above 3.5x 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 renegotiate the covenant well ahead of a possible covenant breach.
- Failure to maintain sufficient liquidity profile

LIQUIDITY AND DEBT STRUCTURE
At end-June 2015, the company had PLN878m of unrestricted cash and equivalents and PLN3.4bn of committed funding (of which PLN2.75bn is available until end-2017) against short-term debt of PLN526. Fitch projects negative free cash flow (FCF) close to PLN2bn for 2016. We assess Tauron's liquidity as sufficient for the next 12 months but medium-term liquidity is weak.

The company faces a large debt maturity of PLN3bn in December 2016, which comprises bonds issued within the bond programme underwritten by banks. We expect Tauron to cover this maturity with its available liquidity at least 12 months ahead of the due date taking into account the negative FCF in 2016. The company plans to refinance the bond programme in the next two months, which will enable it to cover the PLN3bn maturity. Failure to secure sufficient liquidity for debt maturities and capex funding for 4Q16 and 2017 may put additional pressure on the ratings.

In July 2015 Tauron increased committed funding by PLN300m (in the form of a bond programme underwritten by Bank Gospodarstwa Krajowego).

FULL LIST OF RATING ACTIONS
Long-term foreign and local currency IDRs affirmed at 'BBB'; Outlook revised to Negative from Stable
Short-term foreign and local currency IDRs affirmed at 'F3'
National Long-term rating affirmed at 'A(pol)'; Outlook revised to Negative from Stable
National senior unsecured rating affirmed at 'A(pol)'

Contact:
Principal Analyst
Artur Galbarczyk
Associate Director
+48 22 338 6291

Supervisory Analyst
Arkadiusz Wicik
Senior Director
+48 22 338 6286
Fitch Polska S.A.
Krolewska 16
00-103 Warsaw

Committee Chairperson
Paul Lund
Senior Director
+44 20 3530 1244

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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 Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

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