FitchRatings

Fitch Rates Tauron's PLN750 Million Hybrid Bonds 'BB+'

Fitch Ratings-Warsaw/London-19 December 2018: Fitch Ratings has assigned TAURON Polska Energia S.A.'s (Tauron) PLN750 million hybrid bonds due in 2030 a local-currency rating of 'BB+' and national rating of 'BBB+(pol)'. The securities qualify for 50% equity credit.

The hybrid bonds were subscribed by the European Investment Bank (EIB). The proceeds will be used to co-finance capex in distribution. The bonds' rating and assignment of equity credit are based on Fitch's hybrid methodology, dated 9 November 2018 ('Corporate Hybrids Treatment and Notching Criteria' at www.fitchratings.com).

KEY RATING DRIVERS

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Ratings Reflect Deep Subordination: The hybrids are rated two notches below Tauron's Long-Term Issuer Default Rating (IDR; BBB/Stable) given their deep subordination and consequently, the lower recovery prospects in a liquidation or bankruptcy scenario relative to the senior obligations. The notes are subordinated to all senior debt.

Support for the Capital Structure: Fitch expects Tauron's credit metrics to improve once the large-scale capital projects that are underway start contributing earnings and annual capex normalises over the long term. If the group's financial profile has improved by the first call date of the hybrid in 2025, management may decide to refinance the hybrid with senior unsecured debt. If the group's leverage is close to the net debt/EBITDA covenant of 3.5x, which is included in some long-term funding agreements, we expect the management to replace the hybrid with a similar instrument.

Both scenarios are compatible with Fitch's interpretation of permanence. The important aspect is that the hybrid capital will support the capital structure in a stress case.

Second Hybrid Issue: The hybrids will be the second hybrid issuance by Tauron, which in December 2016 issued EUR190 million (PLN814 million) hybrid bonds (rated 'BB+') due in 2034. This issue was subscribed by the EIB. Fitch allocated 50% equity credit to the hybrids. Tauron also signed a PLN400 million hybrid bond issue programme (rated 'BB+' on the international scale and 'BBB+(pol)' on the national scale) with Polish state-owned development bank Bank Gospodarstwa Krajowego (BGK, A-/Stable) in 2017 but no issuance has yet been placed under this programme.

The PLN750 million hybrid bonds with 50% equity credit for seven years, which is a comparatively short period, will marginally improve Tauron's funds from operations (FFO) adjusted net leverage by about 0.1x. While this is not critical for the company's IDR, the hybrids would be excluded from Tauron's net debt in the 3.5x covenant calculation, which is supportive also when considering permanence.

Equity Treatment Given Equity-Like Features: The securities qualify for 50% equity credit as they meet Fitch's criteria with regards to deep subordination, remaining effective maturity of at least five years, full discretion to defer coupons for at least five years, and limited events of default. These are key equity-like characteristics, affording Tauron greater financial flexibility. Equity credit is limited to 50% given the cumulative interest coupon, a feature considered more debt-like in nature.

Effective Maturity Date: The notes are due 12 years from the issue date, which is also the effective maturity date according to Fitch's criteria. The coupon step-up of 75bp from the first call date seven years from the issue date is within Fitch's aggregate threshold rate of 100bp. The equity credit of 50% would change to 0% five years before the effective maturity date, ie seven years from the issue date. The issuer has the option to redeem the notes on the first call date seven years from the issue date and on any coupon payment date thereafter.

Contractual arrangements between EIB and Tauron include the possibility for an incentive-based contribution towards the capital project related to the EU's Juncker Plan, if Tauron complies with its obligations under the project agreement with EIB. These include carrying out the project in accordance with the technical description and within a specified final date, implementation and operation of the project in compliance with EU and Polish environmental legislation and meeting a few corporate governance requirements specified in the project agreement.

Cumulative Coupon Limits Equity Treatment: The interest coupon deferrals are cumulative, which results in 50% equity treatment and 50% debt treatment of the hybrid notes by Fitch. Despite the 50% equity treatment, Fitch treats coupon payments as 100% interest. The company will be obliged to make a mandatory settlement of deferred interest payments under certain circumstances, including the payment of a dividend.

KEY RATING DRIVERS FOR TAURON

High Share of Regulated Business: The ratings reflect the high share of regulated and fairly stable distribution business in Tauron's EBITDA (66% in 9M18; 65% in 2017). We expect it to decrease to about 60% from 2020 due to improving results at the mining division because of higher coal prices as well as the commencement of operations of the new power generation units, under construction by Tauron, in the course of 2019.

Capex to Decrease in 2020: Tauron has been constructing new power generation units in Jaworzno (0.9GW, coal-fired) as well as in Stalowa Wola (0.4GW, combined cycle gas turbine), which is a joint project with Polskie Gornictwo Naftowe i Gazownictwo (PGNiG, BBB-/Stable). We expect Tauron's capex to peak in 2019, when the Jaworzno III power generation unit should come on stream. Tauron's capex should decrease to about PLN3.5 billion-PLN4 billion in 2020-2021, with a positive impact on free cash flows.

At the same time, Tauron's capex will become more focused on distribution, the share of which in capex should increase to around 70% by 2021 from about 50% in 9M18 and 2017. High capex in the distribution segment is positive for Tauron's credit profile as it increases the regulatory asset base in this business segment and helps stabilise results.

Higher CO2 Prices: We expect that Tauron's coal-fired generation business will come only under limited pressure from higher CO2 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.

Tauron benefits from the partial allocation of free CO2 allowances in exchange for environmentally friendly capex, similar to many other central European generation companies. We deem extension of this mechanism for Tauron beyond 2020 as likely, but final decisions have not yet been taken and we assume the free allocation to end in 2020.

Capacity Payments: Tauron participated in the first two auctions for capacity market payments, which were held in November and December 2018, and won - still on a preliminary basis until confirmed by the energy regulatory office - capacity market payments from 2021 and 2022.

Fitch deems the implementation of a capacity payments mechanism in Poland as positive for the electricity generators, including Tauron, as it will support their investments and profitability. It should be a predictable source of EBITDA from electricity generation and can provide additional debt capacity for the current ratings and some rating headroom from 2021.

The European Commission in February 2018 approved the Polish capacity mechanism, which is a key part of the government's plan to support the cash flows of electricity generators that invest in new capacity or in plant modernisation to maintain the country's security of supply.

Leverage Should Stay Within Guidelines: We anticipate that Fitch-calculated funds from operations (FFO) adjusted net leverage will peak in 2019 at planned commencement of operations of the new power generation units in Jaworzno and Stalowa Wola and could temporarily exceed our negative rating guideline of 3.5x. Overall, we forecast FFO adjusted net leverage to average 3.3x in 2018-2021, which leaves some limited headroom under our negative rating guideline of 3.5x.

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, whereas financial implications of such 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.

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 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
- Close to full pass-through of higher CO2 costs in wholesale electricity prices in Poland
- Reduced margins in the supply business to ease impact of higher wholesale electricity prices, in particular on households
- Capacity market payments in 2021-2022 following the first two capacity auctions in November and December 2018
- Total capex at around PLN17 billion over 2018-2021
- PFR investment at Jaworzno project company at PLN880 million
- A maximum bank guarantee of PLN517.5 million for the Stalowa Wola gas-fired power plant joint venture added to Fitch-adjusted debt in 2018-2021
- Reinstatement of dividends from 2020 at around PLN0.4 billion in 2020 and PLN0.5 billion in 2021

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 more conservative 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 and weaker-than-expected operating cash flows
- Business expansion beyond the ongoing projects in coal mining or coal-fired electricity generation or another form of weakening of Tauron's business profile.

LIQUIDITY

Adequate Liquidity: At end-September 2018, Tauron had PLN604 million of unrestricted cash and PLN5.4 billion of committed funding against short-term debt liabilities of PLN293 million and PLN1.9 billion debt due in 4Q19 (comprising mostly the PLN1.75 billion public bonds maturing in November 2019). Fitch expects negative free cash flow of around PLN2.7 billion in 2019.

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Date of Relevant Rating Committee: 7 December 2018

Summary of Financial Statement Adjustments - Fitch-capitalised operating lease with a 7x multiple applied to annual payments. Fifty percent equity credit was allocated to outstanding hybrid bonds.

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

Corporate Hybrids Treatment and Notching Criteria (pub. 09 Nov 2018) (https://www.fitchratings.com/site/re/10051058)
Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10024585)
Country-Specific Treatment of Recovery Ratings Criteria (pub. 16 Apr 2018) (https://www.fitchratings.com/site/re/10026835)
National Scale Ratings Criteria (pub. 18 Jul 2018) (https://www.fitchratings.com/site/re/10038626)
Sector Navigators (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023790)

Additional Disclosures

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