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

FitchRatings

Fitch Rates Tauron's Hybrid Bonds 'BB+'

Fitch Ratings-Warsaw/London-15 December 2016: Fitch Ratings has assigned TAURON Polska Energia S.A.'s (Tauron) EUR190m (PLN843m) hybrid bonds due in 2034 a final rating of 'BB+'. The securities qualify for 50% equity credit. A full list of Tauron's ratings is at the end of this commentary.

The hybrid bonds are to be subscribed by 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 29 February 2016 ('Treatment and Notching of Hybrids in Non-Financial Corporate and REIT Credit Analysis' at www.fitchratings.com).

KEY RATING DRIVERS

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Ratings Reflect Deep Subordination
The notes 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 to 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 2024, 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, management is expected 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.

The EUR190m hybrid bonds with 50% equity credit for eight years, which is a comparatively short period, 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 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 18 years from the issue date. The coupon step-up of 90bps from the first call date in 2024 is within Fitch's aggregate threshold rate of 100bps. However, the second coupon step-up of 11bps from 2029 leads to aggregated step-up of 101bps, which is above Fitch's threshold. As a result, 2029 is the effective maturity according to Fitch's hybrid criteria. The equity credit of 50% would change to 0% five years before the effective maturity date. The issuer has the option to redeem the notes on the first call date eight years from the issue date and on any coupon payment date thereafter.

Fitch is aware that contractual arrangements between EIB and Tauron include the possibility for an incentive-based contribution towards the capital project related to the 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 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 (67% in 2015). 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 and limited fuel mix diversification with a high reliance on coal.

Fitch expects the share of distribution to remain around 65% in 2016-2018, but it may 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.

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 PLN18bn for 2016-2020 (including the cancellation of the PLN1.5bn 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. In June the shareholders agreed to no dividend payments in 2016, compared with a PLN263m dividend paid in 2015.

Fitch views the capex programme as still significant despite the planned reduction in the strategy update. We project FFO adjusted net leverage to increase to about 3.4x in 2016-2018 from 2.4x in 2015, 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 will consider selling to an external investor up to a 50% stake in the Jaworzno III 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.

In our view, the Polish government's plans to introduce a capacity market are crucial in allowing new coal power plants under construction, such as the Jaworzno III plant, to be profitable in the long term. We currently 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 lower share of regulated distribution than Tauron and Energa.

Tauron, Energa and ENEA have limited headroom under their negative rating guidelines due to a projected increase in leverage in 2017-2018 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 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 PLN18bn for 2016-2020.
- No dividends until 2019.
- Tauron's PLN314.5m guarantee for the Stalowa Wola gas-fired power plant JV included in Fitch-adjusted debt calculation.

RATING SENSITIVITIES

Positive: Rating upside for Tauron is limited due to the company's business profile and projected increase in leverage due to capex. However, future developments that could lead to positive rating actions 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 CO2 emissions per MWh, which together with continued efficiency improvements, would result in a stronger business profile.

Negative: Future developments that could lead to negative rating action include:
- FFO adjusted net leverage above 3.5x and FFO fixed charge cover below 5x (2015: 11x) 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: Tauron has improved its medium-term liquidity in the past 12 months after having signed a new PLN6.3bn long-term bond issue programme underwritten by banks in November 2015 and refinanced PLN2.3bn bonds in 1Q16 ahead of maturity in December 2016. At end-September 2016 Tauron had PLN75m of readily available cash and PLN4.5bn of committed funding against short-term debt of PLN1.1bn and Fitch-expected negative free cash flow for 2017 of PLN1.4bn.

FULL LIST OF RATINGS

Fitch currently rates Tauron as follows:

--Long-Term Foreign and Local Currency IDRs 'BBB'; Outlook Stable;
--Short-Term Foreign and Local Currency IDRs 'F3';
--National Long-Term Rating 'A+(pol)'; Outlook Stable;
--National senior unsecured rating 'A+(pol)'.

Fitch has assigned the following rating:

--Hybrid bonds 'BB+'.

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Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016) (https://www.fitchratings.com/site/re/885629)
National Scale Ratings Criteria (pub. 30 Oct 2013) (https://www.fitchratings.com/site/re/720082)
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016) (https://www.fitchratings.com/site/re/886557)
Treatment and Notching of Hybrids in Non-Financial Corporate and REIT Credit Analysis (pub. 29 Feb 2016) (https://www.fitchratings.com/site/re/878264)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?

pr_id=1016520&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJzZXNzaW9uS2V5IjoiRzVVQ0RNTEFVUjFVMUxXT1VFMkYxS0FZQzNTQVpRQ1dFQUJTRVhGWiIsImV4cCI6MTQ4MjQwMjQxNywidXNlcklkIjo4MDI4OX0.WqXFx2Wt10JYl3hEVYmeXt19mKwHDp5SMRvYalcKNPA)
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