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

FitchRatings

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

Fitch Ratings-Warsaw/London-21 December 2017: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB' with Stable Outlooks. Fitch has also assigned Tauron's new PLN400 million (EUR95 million) hybrid bonds programme 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 dominant share of regulated power distribution in Tauron's EBITDA and capex programme, its plans to reduce capex following the expected commencement of operations of new generation blocks in 2019, and reduced financial pressure on credit metrics. The key constraint for the rating is the dominance of coal in Tauron's fuel mix resulting in exposure to carbon dioxide costs in the long term.

The new hybrid bonds will be subscribed by Polish state-owned development bank Bank Gospodarstwa Krajowego (BGK, A-/Stable) and will qualify for 50% equity credit. The hybrid bonds' ratings and assignment of equity credit are based on Fitch's hybrids methodology, "Non-Financial Corporates Hybrids Treatment and Notching Criteria", 27 April 2017, available at www.fitchratings.com.

KEY RATING DRIVERS

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 (72% in 2016). We expect it to decrease to about 65% in 2017-2021 due to improving results at the mining division on the back of rising coal prices as well as the commencement of operations of the new power blocks, under construction by Tauron, in the course of 2019.

Capex to Decrease in 2020: Tauron has been constructing new power blocks in Jaworzno (0.9GW, coal-fired) as well as in Stalowa Wola (0.4GW, CCGT), which is a joint project with Polskie Gornictwo Naftowe i Gazownictwo (PGNiG, BBB-/Stable). Both projects should come on stream in 2019. With their conclusion, Tauron's capex should decrease from about PLN4 billion in 2019 to about PLN3 billion in 2020, with a positive impact on free cash flows.

At the same time, Tauron's capex will become more focused on distribution, which already in 2017 accounted for 51% and from 2020 should exceed 60% of Tauron's capex. 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 in times when another key segment, power generation, will face increasing pressure, in particular because of rising costs of carbon dioxide.

Reduced Financial Pressure: Tauron has undertaken several measures to ease the pressure on debt covenants and leverage. These include the suspension of dividends from 2016 to 2019, a cost-savings programme of PLN1.3 billion in 2016-2018, and the issuance of EUR190 million of hybrid bonds in December 2016. These qualify for 50% equity credit under Fitch's criteria. In addition, Tauron has entered into agreements with a blocking minority of bondholders of the PLN1.75 billion bond programme, effectively relaxing the net debt-to-EBITDA covenant from 3.0x to 3.5x.

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 blocks in Jaworzno and Stalowa Wola. We forecast FFO adjusted net leverage will average 3.3x in 2018-2021, which is below our negative rating guideline of 3.5x.

Tauron should still have some remedies available if needed to reduce leverage. These include the involvement of an additional partner to construct the power block in Jaworzno and inflows from the planned capacity market in Poland, probable from 2021. The enumerated remedies have not been included in Fitch rating case as of now. The new hybrid has a minimal impact on forecast leverage.

Rated on a Standalone Basis: Tauron is 30%-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. On 27 November 2017 Fitch published new proposed criteria as an Exposure Draft "Government-Related Entities Rating Criteria". If the final criteria are substantially similar to the Exposure Draft, we expect Tauron to continue being rated on a standalone basis without any notching for links with the Polish state.

KEY RATING DRIVERS FOR NEW HYBRID

Ratings Reflect Deep Subordination: The notes are rated two notches below Tauron's Local-currency 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 hybrids (seven years from the issue date), 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 hybrids 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 issued under the programme will be the second hybrid issuance by Tauron which in December 2016 issued EUR190 million (PLN843 million) hybrid bonds (rated 'BB+') due in 2034. This issue was subscribed by the European Investment Bank (EIB). Fitch allocated 50% equity credit to the hybrids.

The PLN400m hybrid bonds to be issued under the programme will be eligible for 50% equity credit for seven years after the issue date, which is a comparatively short period. The planned hybrids are small compared to Tauron's total debt and will marginally improve its FFO adjusted net leverage by less than 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 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, a 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 70bp from the first call date seven years from the issue date is within Fitch's aggregate threshold rate of 100bp. There is also an additional coupon step-up of 70bp if Tauron decides to defer coupon payments, but this does not impact the effective maturity of the hybrids. This is because coupon deferrals are likely to be activated by Tauron only in a case of severe financial stress and in such a situation the additional step-up is unlikely to impact the company's decision to call the hybrids early.

The equity credit of 50% will 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.

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.

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.

Of the four Fitch-rated Polish utilities, Tauron has the highest forecast leverage for 2018-2019, which results in limited rating headroom.

KEY ASSUMPTIONS

- Wholesale electricity prices at around PLN160 per MWh
- Average hard coal prices at PLN10 per GJ
- Carbon dioxide market price increasing to about EUR12 per tonne by 2021
- First full-year of generation in Jaworzno coal-fired block (0.9GW) and Stalowa Wola CCGT (50% of 0.4GW) in 2020 implying no further delays
- Weighted-average cost of capital in the distribution segment at 5.6% in 2017 increasing to 6.0% with a 5% qualitative assessment factor (declining return on the distribution's regulated asset base) from 2018
- Capex at PLN18 billion in 2017-2021
- Next dividend payment in 2020 with a 50% dividend payout ratio.

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 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 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

LIQUIDITY

Adequate Liquidity: At end-September 2017 Tauron had PLN2.0 billion of readily available cash and PLN4.4 billion of committed funding against short-term debt of PLN0.3 billion and Fitch-expected negative free cash flow in the next 12 months of PLN1.0 billion.

Large amounts of Tauron's debt will mature over 2019 (PLN2.0 billion) and 2020 (PLN2.9 billion). The company has already gathered funds necessary for refinancing these debt facilities. However, due to capex-driven negative free cash flow in particular by 2019, we expect Tauron to take on some new debt over 2018-2019. We do not anticipate capex funding issues in the medium term despite its exposure to coal.

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'
-- EUR190 million hybrid bonds affirmed at 'BB+'
-- National Long-Term Rating affirmed at 'A+(pol)'; Stable Outlook
-- National senior unsecured rating affirmed at 'A+(pol)'
-- Foreign-currency senior unsecured rating of EUR500 million Eurobonds affirmed at 'BBB'
-- New ratings assigned to Tauron's PLN400 million (EUR95 million) hybrid bonds programme: local currency subordinated rating of 'BB+', and national subordinated rating of 'BBB+(pol)'.

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Summary of Financial Statement Adjustments - Fitch capitalised operating lease with a 7x multiple applied to annual payments. 50% equity credit was allocated to EUR190 million hybrid bonds. Fitch-adjusted debt calculation at end-2016 included the PLN314.5 million guarantee for the Stalowa Wola gas-fired power plant joint venture.

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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 Rating Criteria (pub. 07 Aug 2017) (https://www.fitchratings.com/site/re/901296)
Exposure Draft: Corporate Rating Criteria (pub. 14 Dec 2017) (https://www.fitchratings.com/site/re/907387)
Exposure Draft: Government-Related Entities Rating Criteria (pub. 27 Nov 2017) (https://www.fitchratings.com/site/re/899535)
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
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