FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Poland's Tauron to 'BBB-'; Outlook Stable

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Fitch Ratings - Warsaw - 21 May 2020: Fitch Ratings has downgraded TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BBB-' from 'BBB'. The Outlook on the IDRs is Stable. A full list of rating actions is below.

The downgrade reflects losses in Tauron's mining division, delay in launching a new power block in Jaworzno, and lower demand for electricity due to the pandemic-driven economic crisis affecting all business units, including distribution, which does not benefit from an automatic volume correction mechanism. We therefore forecast Tauron's funds from operations (FFO) net leverage to be too high for the previous rating, but comfortable for the 'BBB-' IDR, as reflected in the Stable Outlook.

KEY RATING DRIVERS

Mining under Pressure: Tauron's mining division has been loss-making since 2016. However, in 2019 losses peaked at PLN0.5 billion triggered by lower production (down to 3.8MT in 2019 from 5MT in 2018) and higher costs of production. For 2020 we expect smaller losses and from 2021 a neutral result due to works carried out over 2019-2020. However, falling coal prices may lead to prolonged losses in this segment despite operational improvements.

Leverage Peak in 2019-2020: High capex and acquisitions, losses in the mining division and a negative swing in working capital drove Tauron's FFO net leverage higher to 4.3x in 2019. In 2020 the company will face further operational challenges in mining (aiming for smaller losses) and conventional generation (launching the delayed 0.9GW project in Jaworzno and an equity-accounted 0.45GW project in Stalowa Wola, ECSW), but also consequences of the economic downturn triggered by the pandemic. Consequently, we do not expect material improvement in FFO net leverage, which we project to remain above 4.0x in 2020.

Higher Leverage Maintained: Receipt of capacity payments and commencement of operations of the Jaworzno power block should lead to FFO net leverage decreasing from 2021. Nevertheless, leverage will remain quite high due to capex and acquisitions related to energy transition, undertaken in line with Tauron's new strategy and wider trends across the EU. Some relief may come from divestments, e.g. of the heating business or ECSW, but these have not yet materialised and are not included in our rating case. We expect FFO net leverage to average 3.7x over 2021-2024, which is above the previous negative sensitivity of 3.5x, but comfortable for the current 4.5x sensitivity.

Mining Increases Business Risk: Mining is the highest-risk segment of Tauron's business and impacts negatively the company's credit profile. Tauron has been investigating options to divest one of its three mines in 2019, but closed the process having received no bids. Some relief may come from the government plan for the coal mining industry in Poland as the majority of the sector faces similar weaknesses related to high production costs and falling prices of coal. The plan is currently under preparation and should be announced later this year.

New Strategy: Tauron published a new strategy in 2019. It targets a 66% share of zero or low-carbon-intensive capacity, decommissioning of all old coal-fired generation units and reduction in its carbon footprint by 50%, all by 2030. Execution of the new strategy could be delayed if Tauron decides to postpone some of the projects due to the pandemic. Nevertheless, the new strategy is an indication of the company's intention to pursue energy transition, which follows the EU's decarbonisation policy and climate-neutrality goal for 2050.

Delayed Jaworzno Project: Commencement of operations of Tauron's 0.9GW coal-fired block in Jaworzno has been delayed to November 2020 following the damage to one of the boiler components while conducting the final tests in February 2020. This is negative for the credit profile as it delays the receipt of operating cash flow from the new unit. However, it is partially mitigated by purchase of electricity from the wholesale market at currently low prices to deliver the volumes contracted earlier from the Jaworzno power plant.

Setting up Renewables Division: In 2019 Tauron acquired five wind farms with a total capacity of 180MW and separated its renewables division in corporate reporting from 2020. All in, Tauron's wind assets increased to 381MW and all renewables (counting in hydro and biomass) to 659MW at end-2019. Expansion in renewables is one of the key strategic targets for Tauron and will impact positively its business profile, even if it will require sizeable investments, in our view.

High Share of Regulated Business: The ratings reflect a high share of regulated and fairly stable distribution business in Tauron's EBITDA (74% in 2019). Results in the distribution business depend predominantly on return from its regulatory asset base, but there is some exposure to short-term volatility of distribution volumes. The volumes are normally stable, but the pandemic will drive them lower in 2020. Tauron may try to regain the difference between the forecast and actual volumes in 2021, but the mechanism is not automatic, in contrast to many other European markets.

Capacity Payments Provide Stability: Tauron has won capacity payments and will receive around PLN0.65 billion a year of additional revenue from this source in 2021-2025. Capacity payments will account for around 15% of EBITDA, which we treat as quasi-regulated. Capacity payments support Tauron's credit profile as they are a more reliable source of cash flow than selling electricity to the wholesale market.

Energy Transition in Poland: The Polish electricity market has been historically dominated by coal-fired generation and therefore offers better market conditions for conventional generators. However, favourable conditions will gradually disappear with the limitation of non-auction allocation of CO_2 allowances, expiry of capacity payments for most of coal-fired units from 2026 (excluding new units like Jaworzno) and continuous expansion of wind and photovoltaic generation pushing out coal-fired power plants from the merit order. We also expect coal generators to face more difficulties such as tighter emission rules and more expensive financing due to a lower number of financial institutions providing funding to coal-related industries.

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 a default by Tauron as moderate, but the financial implications of such a default as weak. Consequently, we do not apply any rating uplift for links with the Polish state and Tauron is rated on a standalone basis.

ESG Influence: ESG issues impact the ratings primarily through a dominant share of coal in Tauron's fuel mix, but also through the coal mining business, which is hit by both economics of the market and the global push for renewables.

DERIVATION SUMMARY

Tauron's close peer group includes the three other electricity-focused integrated utilities in Poland, which are PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB/RWN).

Tauron's and Energa S.A.'s business profiles benefit from the large share of regulated distribution in EBITDA, which provides good cash-flow visibility when conventional generation and mining are under pressure.

PGE is the largest company and has the lowest leverage among the peer group. It derives most of its EBITDA from electricity generation and has a high share of lignite in the generation fuel mix, which provides the company with cost advantage over hard coal-fired peers such as Tauron and ENEA. Rising CO2 prices could diminish this cost advantage if not accompanied by high hard coal prices, given the higher carbon footprint of lignite than hard coal.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time higher exposure to hard coal-fired generation, but controls a profitable mining business. The maximum leverage sensitivity for ENEA's 'BBB' rating is 3.0x.

Across central Europe a close peer is also CEZ, a.s. (A-/Stable), whose higher rating mainly reflects a low-cost generation fleet, a lower carbon footprint and lower leverage.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Wholesale electricity prices at PLN230 per MWh (megawatt hour), hard coal prices at PLN11.7 per GJ (gigajoule), prices of CO2 allowances at EUR20 per tonne (all on an average, annual basis until 2024);

- Pass-through of CO2 prices to wholesale electricity prices;

- Electricity generation volumes down about 10% in 2020 with rebound from 2021;

- Commencement of operations of the Jaworzno power plant in November 2020 with parallel shutdown of the oldest 120MW units;

- Annual revenue from capacity payments at around PLN0.65 billion over 2021-2025;

- EBITDA in mining negative in 2020 and neutral from 2021;

- Weighted-average cost of capital in the distribution segment at 5.5% over 2020-2024;

- Capex at PLN18 billion over 2020-2024; and

- Continuation of a zero-dividend policy over 2020-2024.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- FFO net leverage below 3.5x on a sustained basis;

- A more diversified fuel generation mix with increase in zero or low carbon-intensive generation assets; and

- Focus on regulated and quasi-regulated business in capex and overall strategy.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO net leverage above 4.5x and FFO interest cover below 5x on a sustained basis, for example due to higher capex, acquisitions or reinstatement of dividends or problems in getting a waiver in case of a covenant breach;

- Weaker EBITDA or working capital outflows, for example due to economic downturn, under-performance of the mining division, tariff deficit or further delays in the launch of Jaworzno or ECSW new power blocks; and

- Weakening of Tauron's business profile, for example due to delays in implementation of new strategy or increased exposure to higher-risk businesses.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-March 2020 Tauron had PLN807 million of readily available cash and PLN2,083 million of committed credit facilities. This was against debt maturities of PLN187 million in 2020, PLN336 million in 2021 as well as Fitch-expected negative free cash flow (FCF) of PLN522 million in 2020 and PLN533 million in 2021. Tauron has sufficient liquidity until 2022, when PLN5.3 billion of a consortium loan will mature.

Higher, but Manageable Covenant: The main covenant included in Tauron's loan arrangements is net-debt-to-EBITDA of up to 3.5x. Net debt-to-EBITDA increased to 3.27x at end-March 2020 from 2.8x at end-2019 and may increase further during 2020 depending on EBITDA reported in the following quarters. Although increasing, we view its level as manageable for Tauron. It can postpone some of capex or operating spending to 2021, while EBITDA will be materially higher on capacity payments.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-adjusted debt calculation included guarantee for the ECSW gas-fired power plant joint venture. Fifty percent equity credit was allocated to outstanding hybrid bonds.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Tauron has ESG credit relevance scores of 4 in categories "Emissions from Operations" and "Fuel Use to Generate Energy". This is due to over a 90% share of hard coal in its electricity generation mix, which is carbon-intensive and under pressure in the EU, and an unprofitable coal-mining business.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
TAURON Polska Energia S.A.	LT IDR	BBB-	Downgrade
	ST IDR	F3	Affirmed
	LC LT IDR	BBB-	Downgrade
	LC ST IDR	F3	Affirmed
	Natl LT	A(pol)	Downgrade
• subordinated	LT	BB	Downgrade

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Short-Term Ratings Criteria (pub. 06 Mar 2020)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Corporate Finance Utilities and Power Europe Poland