FITCH REVISES TAURON'S OUTLOOK TO STABLE; AFFIRMS AT 'BBB'

Fitch Ratings-Warsaw/London-14 November 2016: Fitch Ratings has revised TAURON Polska Energia S.A.'s (Tauron) Outlook to Stable from Negative and affirmed the Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BBB'. A full list of rating actions is available at the end of this commentary.

The Outlook revision reflects Tauron's measures to support the company's financial profile over the next five years, including a reduction of long-term planned capex and management's plan of no dividends until 2019. The Stable Outlook also reflects the reduced risk of covenant breach and improved medium-term liquidity since 4Q15 when the Outlook was revised to Negative.

We project funds from operations (FFO) adjusted net leverage to increase to about 3.4x in 2016-2018 from 2.4x in 2015. This is close to our view of maximum net leverage for the ratings of 3.5x, resulting in limited rating headroom for Tauron.

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 (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.

We expect 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.

In our view the capex programme remains 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. This compares with a previously expected higher leverage peak of 3.8x in 2018. However, with the now Stable Outlook it also means Tauron has limited room for underperformance or additional capex or acquisitions.

Reduced Risk of Covenant Breach

Tauron has managed to reduce the risk of a covenant breach in the next few years when leverage is expected to peak. This is because in addition to the reduced leverage peak, Tauron has eliminated the risk of early repayment of the PLN1.75bn bonds if the net debt-to-EBITDA covenant is above 3x but below 3.5x due to agreements signed with the investors holding about 40% of the bonds while new funding includes a more relaxed covenant of 3.5x compared with 3.0x previously.

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. The company is also considering a placement of a hybrid bond of about PLN0.8bn to European Investment Bank. Such a hybrid bond would be excluded from Tauron's net debt in the covenant calculation.

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 of 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.

Of the four Fitch-rated Polish utilities Tauron has the highest forecast leverage for 2017-2018, which results in limited rating headroom.

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% qualitative assessment factor (declining 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. We treat this as event risk and a potential corporate governance issue.

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.

Tauron has also tightened its funding approach by pre-arranging committed funding at least 24 months ahead of actual funding needs, compared with at least 12 months previously. The company plans to extend debt maturities in the next few months ahead of the next large maturity of PLN2bn in 2019.

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 RATING ACTIONS

Long-Term Foreign and Local Currency IDRs affirmed at 'BBB'; Outlook revised to Stable from Negative
Short-Term Foreign and Local Currency IDRs affirmed at 'F3'
National Long-Term Rating affirmed at 'A+(pol)'; Outlook revised to Stable from Negative
National senior unsecured rating affirmed at 'A+(pol)'

Contact:

Principal Analyst
Artur Galbarczyk
Associate Director
+48 22 338 6291

Supervisory Analyst

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

Committee Chairperson
Josef Pospisil, CFA
Managing Director
+44 20 3530 1287

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com; Malgorzata Socharska, Warsaw, Tel: +48 22 338 62 81, Email: malgorzata.socharska@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
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