S&P Global
Ratings

RatingsDirect®

Research Update:

Czech Gas Transmission Company NET4GAS 'BBB' Rating Affirmed On Shareholder Loan Redemption; Outlook Stable

Primary Credit Analyst:
Sarah Harkins, CFA, London +44 (20) 7176 3716; sarah.harkins@spglobal.com

Secondary Contacts:
Anna Brusinets, Moscow +7 (495) 7834060; anna.brusinets@spglobal.com
Beatrice de Taisne, CFA, London (44) 20-7176-3938; beatrice.de.taisne@spglobal.com

Table Of Contents

Research Update:

Czech Gas Transmission Company NET4GAS 'BBB' Rating Affirmed On Shareholder Loan Redemption; Outlook Stable

Overview

- We are affirming our long-term 'BBB' rating on NET4GAS following the company's decision to redeem its shareholder loans.
- We anticipate that, following this transaction, NET4GAS' credit metrics will continue to meet our expectations for the 'BBB' rating.
- The outlook remains stable.

Rating Action

On June 28, 2016, S&P Global Ratings affirmed its 'BBB' long-term corporate credit rating on Czech gas transmission and transit grid operator NET4GAS s.r.o. (NET4GAS). The outlook is stable. We also affirmed the 'BBB' rating on NET4GAS' senior unsecured debt.

Rationale

The affirmation follows NET4GAS' decision to redeem its Czech koruna (CZK) 11 billion (€406 million) shareholder loans. We understand from the management team that NET4GAS will fund this redemption using CZK6,600 million of equity contributed by its existing shareholders, CZK2,500 million from cash reserves and debt drawdown, and CZK1,900 million gained by netting off loans its parent, NET4GAS Holdings, owes to it.

We consider that the effect of the redemption on credit metrics from the increase in net debt of CZK2.5 billion (€90 million) will not significantly change our assessment of NET4GAS' financial risk. We expect NET4GAS to return to funds from operations (FFO) to debt above 18% in the long term, although its credit metrics will deteriorate temporarily to around 16% FFO to debt in 2017 and 2018 while it completes the Czech-Polish Gas Interconnector (CPI) project.

We understand that the redemption of the shareholder loan stems from NET4GAS' ambition to comply with the expectations of the Czech Republic's National Regulation Authorities (Energy Regulatory Office) and the Polish regulator's request that the CPI project be funded at least 70% from common equity. This project has an estimated total cost of around CZK10.6 billion (€386 million).

We consider NET4GAS' shareholders, Allianz Group and Borealis Infrastructure, to be strategic owners that have a long-term investment horizon. We expect that they will continue to contribute equity over the next three years to support the new project's capital expenditure (capex) requirements. The project is expected to be completed in 2019.

In our view, NET4GAS' strong business risk is supported by the stable and predictable cash flows from ship-or-pay contracts in the transit business, which account for about 80% of revenues, and from its regulated gas transmission operations in the Czech Republic, which offer low volatility of earnings and above-average profitability, as defined in our criteria. That said, we understand that, from 2020, when most of its ship-or-pay transit contracts are due to expire, NET4GAS' contract portfolio will include an increased share of short-term bookings. This could increase the volatility of cash flow generation and put pressure on profitability. In addition, we consider that NET4GAS' customer concentration to Gazprom--a large Russian gas producer, exporter, and government-related entity--is a key risk because we estimate that Gazprom contributes about 56% of NET4GAS' revenues. However, the relationship remains stable and supported by long-term ship-or-pay contracts. The route via the Czech Republic is important for the delivery of Russian gas to European consumers.

In our view, NET4GAS' significant financial risk is underpinned by relatively stable FFO to debt, which we expect will be around 16%-19% from 2016–2018 as it completes its CPI project. Although NET4GAS' capex will be high until the project is completed, once completed CPI should contribute stable regulated income to the company, which will support its metrics returning to above 18% FFO to debt.

In our base case, we assume:
- Transit revenues based on existing long-term contracts;
- Domestic transmission revenues based on the existing regulatory period to end-2018;
- Capex of CZK710 million in 2016 and around CZK3 billion in 2017; and
- Equity contribution of CZK6.6 billion in 2016.

Based on these assumptions, we arrive at the following credit measures:
- FFO to debt of 19% in 2016 and about 16% in 2017-2018, increasing to more than 18% thereafter; and
- Debt to EBITDA of 3.7x in 2016 and 4.4x-4.7x in 2017-2018.

Liquidity

We assess NET4GAS' liquidity position as strong, as we expect its ratio of sources to uses of funds will be at least 1.5x over 2016 and at least 1x over 2017. We consider that NET4GAS conservatively manages interest rate currency risk by using a combination of swaps and natural hedges. NET4GAS' debt does not have any financial covenants.

The company's liquidity sources, as of March 31, 2016, comprised:
- Unrestricted cash of about CZK2.2 billion;
- FFO that we estimate at about CZK5,400 million in 2016; and

- An undrawn committed revolving credit facility of €100 million, expiring in 2019.

We anticipate that cash outflows for 2016 will include:

- Capex of about CZK1,270 million;
- Dividends of about CZK2,700 million (including interest paid on the shareholder loan); and
- Net repayment of the shareholder loans of CZK2.5 billion.

Outlook

The stable outlook reflects our opinion that NET4GAS will continue to be supported by stable gas transit demand, a supportive regulatory environment, and successful delivery of its capital projects, which will benefit from compensation arrangements with the Czech Republic energy regulator.

Downside scenario

We would consider a downgrade if the adjusted FFO-to-debt ratio does not sustainably increase above 18% by 2019-2020 after a temporary deterioration of FFO to debt of about 16% in 2017-2018. We could also lower the rating if the volatility of earnings or level of EBITDA margins changed significantly. This could occur, for example, as a result of changes to the regulatory regime, increased volatility stemming from the greater proportion of short-term contracts in the revenue base, unexpected operational problems, nonpayment from counterparties, or higher operating expenses or capex than we currently anticipate.

Upside scenario

We may consider an upgrade if NET4GAS' sustains credit metrics of FFO to debt above 23%, successfully completed its capex program on time and within budget, and at the same time its relationships with key customers remain stable.

Ratings Score Snapshot

Corporate credit rating: BBB/Stable/--

Business risk: Strong

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Strong

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

NET4GAS s.r.o.	
Corporate Credit Rating	BBB/Stable/--
Senior Unsecured	BBB

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.