FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Net4gas at 'BB+'; off RWN; on Negative Outlook

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Fitch Ratings - Milan - 19 Oct 2022: Fitch Ratings has affirmed Net4gas, s.r.o.'s Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BB+' and removed them from Rating Watch Negative. The Outlook on the Long-Term IDR is Negative.

Fitch's base scenario now incorporates full or near-complete shut-off of Russian pipeline gas to Europe and no payments from Gazprom. We now base our analysis on Net4gas's capacity to carry alternative flows, and to thus receive capacity bookings to service demand nationally and from neighbouring eastern European countries, as well as for the north-to-south German transit.

Net4gas maintains strong liquidity and the Negative Outlook reflects uncertainties related to the magnitude of alternative transits, related profits as well as the shareholders' commitment towards a lower leverage.

KEY RATING DRIVERS

Long-Term Contracts at High Risk: We see a material risk of the long-term ship-or-pay transit contracts between Net4gas and Gazprom not being fulfilled, due to the continuous escalation of sanctions and no Russian gas transit through the pipeline at present. Gazprom's payments account for a large majority of Net4gas's revenue.

Cashflow From Alternative Flows: While we acknowledge that Gazprom's ability to pay has not been hampered by sanctions and it is honouring the contract with Net4gas at present, we now assess the latter's credit risk under a scenario of alternative flows, given the extremely high risk of non-payment by Gazprom in the future. We acknowledge that Net4gas may be entitled to some form of compensation, but any additional monthly payment, Russian gas transit or financial compensation would represent an upside to our forecast.

Structurally Lower EBITDA: Our new projections see slightly below 33 billion cubic meters (bcm) of non-Russian gas transited through Net4gas' pipelines to meet demand nationally, from German intra-country and from neighbouring CEE countries. Such transits are expected to be based on short- term capacity bookings, leading to our estimates of 30%-35% lower transit EBITDA compared with our pre-Ukrainian conflict estimates. Overall, we expect an average EBITDA of CZK5.5 billion over 2024-2026.

Risks and Upside to Forecasts: The key uncertainties over the assumed alternative transits include the large Hungarian imports directly through the Turkish Stream route, the infrastructural debottleneck between north and south Germany as well as the level of Ukrainian imports. New long-term contracts would represent an upside to visibility and the business profile.

FCF Mitigates Leverage Rise: Under our assumptions of payments only related to alternative flows from 4Q22 onwards, we expect funds from operations (FFO) net leverage to increase sharply in 2023 to 7.0x. However, we expect Net4gas to generate pre-dividend free cash flow (FCF) of more than CZK3.2 billion in 2022, and cumulative FCF of CZK6.9 billion in 2023-2025, leaving the group with enough levers to progressively deleverage to within our updated sensitivities barring substantial shareholder distributions. We forecast 4.5x FFO net leverage at end-2025. No medium-term leverage commitment has been expressed so far by Net4gas, while dividends are temporarily suspended "until the risk of an external shock materialising has significantly reduced".

Solid Regulatory Framework: Net4gas's business profile benefit from its role as national transmission system operator (TSO), which would account for around 30% of its operating cash flow generation in our updated estimates. Gas transmission is fully regulated within a transparent and supportive framework and currently in their fifth regulatory period (RP5), which provides cash flow visibility up to 2025.

Protection Against Volume Risk: Net4gas's regulatory framework shields the company from a potential reduction in intra-state transmitted volumes arising from warmer temperatures or a lack of supply, through regulatory compensation with a two-year time lag. Further, in case of state of emergency, new amendments to the Czech Energy Act would allow TSOs to ask for compensation in the same year directly from the state budget for any intra-state capacity fees lost. Such amendments would also smooth cash flow volatility arising from the risk of gas supply curtailments to Czech industrial sectors.

Investment-Grade Debt Capacity: Under Fitch assumptions, Net4gas's international transit activities would almost exclusively stem from annual or monthly "ship-or-pay" bookings, compared with the current large long-term agreements with Gazprom. Under these circumstances the maximum FFO net leverage for an investment-grade rating would be around 4.3x, assuming a good credit quality of alternative shippers and the benefits of the solid features of the TSO business.

DERIVATION SUMMARY

eustream, a.s. (BBB/Negative; 'bbb-' Standalone Credit Profile) is Net4gas's closest rated peer since both companies own and operate gas transit pipelines in Slovakia and the Czech Republic, respectively, although Net4gas benefits from a higher share of domestic business with more supportive regulation and no potential liabilities related to historical gas-in-kind hedging. Both companies are highly dependent on the Russian gas transit to Europe, with concentrated counterparty risk in Gazprom while eustream's balance sheet is significantly less leveraged (around 2.0x FFO net leverage vs. 4.0x historically for Net4gas).

Net4gas is in a weaker competitive position than fully regulated national TSO peers such as Snam S.p.A. (BBB+/Stable) and REN - Redes Energeticas Nacionais, SGPS, S.A. (BBB/Stable) and pure gas distributor Czech Gas Networks Investments S.a r.l (BBB/Stable). The latter shares the same country, regulator and a supportive fifth regulatory period as Net4gas, but its earnings from traditionally regulated networks allow for a higher debt capacity than ship-or-pay contracts, especially if the latter are short-term in nature.

Furthermore, under our current corporate rating methodology, ship-or-pay contracts do not intrinsically strengthen recovery prospects for senior creditors, and, therefore, do not allow Net4gas's senior unsecured debt to be notched up from the IDR, unlike that of Czech Gas Network Investment, given the dominant contribution of high-quality regulated activities.

KEY ASSUMPTIONS

-Cash flows related to only alternative flows from 4Q22 onwards

- TSO revenues based on the current regulatory framework for 2021-2025 (RP5), which entails a weighted average cost of capital set at 6.43%, the alignment of regulated asset base (RAB) with net asset value within RP5 and the inclusion of MCE investments in RAB in 2022

-Alternative transited gas flows run on short-term bookings up to 24bcm in the medium term (on top of domestic consumption)

- Transit operating expenditure reduced by 30%-35% from 2023 onwards, reflecting estimated potential rationalisation

- Cumulative capex of CZK 8.8billion in 2022-2026, assuming some estimated potential rationalisation

-No dividend payments from 2022 onwards and internally generated cash sufficient to fully repay 2025 and 2026 debt at maturity

RATING SENSITIVITIES

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

-Due to the Negative Outlook, an upgrade of Net4Gas is unlikely in the near future

-We would revise the Outlook to Stable when visibility on gas flow and revenue from gas transit is enhanced, coupled with a structural FFO net leverage below 5.0x

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

-FFO net leverage sustainably above 5.0x

- Evidence of permanent loss of a large part of current transit income that is replaced by lower-than-expected alternative bookings

-Reinstatement of dividend distribution while current gas-market uncertainties remain

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 sectorspecific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Net4gas's adequate liquidity is supported by the cash-generative nature of the gas transport business, leading to positive pre-dividend FCF generation under normal conditions. Its next debt maturities are not until 2025 (around CZK10 billion) and 2026 (around CZK5 billion). Net4gas does not have an undrawn committed credit line, but had at end-August accumulated around CZK6.6 billion of cash and cash-equivalents.

ISSUER PROFILE

Net4gas is the Czech Public national gas TSO, and a crucial infrastructure for gas transit from Russia to European markets. With a large bi-directional flows capacity, Net4gas operates a large-scale high-pressure gas transmission and transit system of 3,973km of pipelines.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance 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 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 ⬍		PRIOR ⬍
NET4GAS, s.r.o.	LT IDR Affirmed	BB+ Rating Outlook Negative	BB+ Rating Watch Negative

senior unsecured	LT	BB+	Affirmed		BB+ Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country-Specific Treatment of Recovery Ratings Criteria (pub. 05 Jan 2021)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 15 Oct 2021) (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), v8.0.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

NET4GAS, s.r.o.	EU Issued, UK Endorsed

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