

FITCH AFFIRMS NET4GAS AT 'BBB'; OUTLOOK STABLE

Fitch Ratings-London/Warsaw-30 June 2017: Fitch Ratings has affirmed NET4GAS, s.r.o.'s (N4G) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The rating affirmation reflects N4G's strong business profile as the sole national gas transmission system owner and operator in the Czech Republic, the supportive three-year regulatory determination for its domestic regulated business that started in 2016, as well as potential upside and a higher share of contracted revenues if Nord Stream II (NS II) is commissioned.

KEY RATING DRIVERS

Significant Transit Contract Optionality: Fitch assumes N4G's contractual portfolio in our forecast, but due to pending approvals for NS II, we exclude Gazprom's related capacity bookings (up to 40 billion cubic metres per year) with N4G. This means decreasing cash flow visibility from 2020 as expiring contracts may not be fully replaced by short-term bookings. However, this is offset by lower dividends, and we expect key credit metrics to remain commensurate with the ratings. If NS II is approved, we would also expect N4G's credit metrics to support its ratings as we assume N4G's initial related capex of around EUR540 million to be equity funded, and for the additional earnings to support increased shareholder returns.

Temporarily Higher Leverage: Fitch forecasts slightly higher funds from operations (FFO) adjusted net leverage with its peak in 2017 at 5.6x (5.3x on average) due to the timing difference between the equity injections towards the Czech-Polish Interconnector (CPI) investment in 2022 and the CZK11 billion shareholder loan redemption in 2016, CZK2.5 billion of which was paid back in cash. The CPI project has been delayed by two years, with stepwise commissioning expected in 2021 and 2023. Fitch acknowledges that it will take longer than we initially expected for the domestic part of CPI to be included in the regulatory asset base (RAB) due to the delay; however, we continue to focus on metrics with the project fully implemented.

A change in shareholders' commitment to equity funding of N4G's additional capex (also related to CPI) or in the flexible dividend policy would be negative for the rating.

Increasing Counterparty Risk: N4G's counterparty exposure to Gazprom (BBB-/Stable) would increase if NS II were approved. This does not constrain the ratings due to the historical performance under the contracts, the higher unconstrained credit profile of the counterparty, and the continued importance of N4G's transit route in reaching shippers' ultimate customers and source of cash flows, in our view.

Other counterparties include large European utilities. All counterparties (transit or domestic) have to meet the criteria of the network code, and payments are typically made on advance invoices. The regulatory framework allows recovery of revenue deficits in the domestic business.

Maturing Regulatory Environment: Fitch views the Czech Republic's regulatory environment as relatively transparent and maturing. Material discrepancy between the book value and the RAB value is an issue, but is common for regulated utility companies in eastern European countries. Evolving from Regulatory Period 3 (RP3, 2010-2015), the weighted average cost of capital (WACC) is fixed for the entire regulatory period, consistent with most western European peers. Draft price determination for RP5 (2019-2023) is expected in September 2017.

Long-Term Transit Contract Expiry: Following the maturity of more than half of east-west bookings in January 2017, four more long-term contracts will mature during our rating horizon (2017-2022). Fitch believes the contracts, especially the traditional east-west route across Ukraine, are unlikely to be renewed. However, Fitch expects some of the reverse gas flows (west-east) to be sustained on an uncontracted/short-term contract basis given that there are no alternative routes to deliver gas to Slovakia then to Italy (via Austria) and Ukraine (Exit Lanzhot).

FX Exposure: Fitch expects an increasing share of transit revenues in Czech koruna (CZK), which is also the currency for the domestic business, given new contracts to be denominated in CZK. New loans are also drawn in CZK in anticipation of a decreasing share of revenues in US dollars after 2021. In total, domestic transport and transit businesses generate more than half of N4G's revenue in CZK, followed by US dollars and euros. Costs are largely in CZK. N4G targets a cash flow hedge of FX using debt issued across the currencies and cross-currency swaps, while balance sheet ratios and net income are impacted by currency fluctuations.

DERIVATION SUMMARY

eustream, a.s. (A-/Stable) is N4G's closest rated peer since the two companies own and operate the gas transit pipelines in Slovakia and the Czech Republic respectively, although N4G also benefits from domestic gas regulation. Both companies are highly dependent on Russian gas transit to Europe with concentrated counterparty risk. N4G is in a weaker competitive position than its peers, Terna S.p.A. (BBB+/Stable) and REN - Redes Energeticas Nacionais, SGPS, S.A. (BBB/Stable), since Fitch considers earnings from traditionally regulated networks to be more visible than long-term ship-or-pay contracts. No Country Ceiling, parent/subsidiary or operating environment aspects impact the rating.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Short-term bookings of 72GWh/day annually for 2017-2019 (98GWh/day in 2015 and 84GWh/day in 2016);
- Capex over CZK10 billion for 2017-2021;
- CPI capex to be 70% equity funded;
- Regulatory returns in line with the determination for RP4 (2016-2018); and
- Flexible dividend policy (CZK3 billion dividend assumed for 2017).

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Expected FFO net adjusted leverage sustainably below 4.7x and FFO interest coverage above 3.5x, supported by shareholders' commitment and earnings from long-term ship-or-pay transit contracts with diversified counterparties and domestic business.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Projected FFO net adjusted leverage at above 5.2x and FFO interest coverage at below 2.5x on a sustained basis.
- Adverse change in N4G's contract portfolio or failure of counterparties to perform under the contracts.
- Significant weakening of the unconstrained credit profile and increase in exposure to N4G's key counterparty.
- A deterioration in the domestic regulatory environment for gas transmission.

LIQUIDITY

No Refinancing Risk until 2021: In May 2017, CZK5.7 billion and USD54 million (around CZK1.4 billion) term loans due in 2018 were refinanced, all in CZK, until 2022 and the company has no immediate refinancing risk at least until 2021. N4G's liquidity is supported by a currently undrawn EUR100 million (around CZK2.7 billion) revolving capex facility available until 2022,

which can be utilised in euros, dollars or koruna, and strong pre-dividend free cash flow supported by the cash-generative nature of its business. The shareholders are prudent in their dividend policy with a clear intention of maintaining a strong investment-grade rating.

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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

Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)

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