

04 MAR 2022

## Fitch Places Net4gas on Rating Watch Negative

Fitch Ratings - Milan - 04 Mar 2022: Fitch Ratings has placed Net4gas, s.r.o.'s Long-Term Issuer Default Rating (IDR) and senior unsecured rating of 'BBB' on Rating Watch Negative (RWN).

The RWN reflects the increased and rising risks to Gazprom's (B/RWN) willingness and ability to honour its obligation under its "ship-or pay" gas transit contracts with Net4Gas, which make up more than 70% the company's revenues. This follows tightening sanctions on Russia and its corporates and Russia's own restrictions since its military invasion of Ukraine last week as well as Europe's growing desire to reduce its energy imports from Russia.

We will resolve the RWN once we have better long-term visibility of the transit business and Net4gas's target financial profile, assuming significant changes in the European gas market. This could take longer than six months

### Key Rating Drivers

**Risk of Short-term Disruption:** The escalating sanctions with possible political will to halt or reduce gas flows to Europe and military actions in Ukraine pose multiple risks to the usual gas and FX cash flows from Russia to Europe. Physical flow disruptions are now a possibility, but would not pose contractual risk for Net4Gas as Gazprom would still be obliged honour the contracts.

**Outright Sanctions Damaging:** Potential sanctions that would limit Gazprom's ability to pay or Net4Gas's ability to make available and operate its pipelines would undermine these contractual obligations, with major consequences for the company.

**Uncertainty of Evolving Business Profile:** We expect the crisis to increase the European energy market's focus on energy independence, especially with regards to Russia, and security of supply. We foresee Net4gas's infrastructure will continue to play an important role in the European gas market, but also expect its business profile to materially evolve.

**NSII Freeze:** The majority of Net4gas's long-term booked capacity is for Russian gas routed through Nord Stream I (NSI) and potentially Nord Stream II (NSII), in the respective north-west (until 2035, Gazelle) or north-east directions (2039, C4G). Contractual ship-or-pay C4G is not dependent on NSII being commissioned. However, following Germany's ban on NSII, the mismatch between available long-term booked capacity and the actual (lack of) gas flow is material, increasing the risk of attempts for renegotiation in the medium term. The main mitigant of this is the actual use of the C4G infrastructure for Gazprom's gas flows not originating from NSII.

**Cash-Generative Business:** Net4gas's transport and transit businesses are highly cash generative, leading to a historical and projected EBITDA margin above 80%. In unaffected geopolitical circumstances, we expect EBITDA and FFO to remain largely stable, at an average of CZK7.4 billion and CZK5.5 billion in 2022-2026, respectively, underpinned by a solid RP5 framework and stable contracted capacity above 60 billion cubic metres (bcm)/year.

We expect investments to spike in 2022 at CZK5.5 billion along with the commitments of the MCE project (extension of the gas transportation capacity in the Moravian territory) and then progressively decrease

to around its maintenance level of CZK0.9 billion in 2024-2026, freeing up large pre-dividend free cash flow (FCF).

**Supportive Fifth Regulatory Review:** Czech Republic's transparent and stable gas transportation regulation supports Net4gas's business profile and represents around 20% of EBITDA. RP5 is covering 2021-2025, in broad continuity with the past, incorporating a decrease to 6.4% in the allowed real rate of return.

The newly introduced mechanism for full convergence of the regulated asset base (RAB) with net book value by 2025 would support Net4gas's allowed profit. This would enable allowed revenue to progressively increase to about CZK2.3 billion in 2025 (up by 23% vs 2020), also considering the 95% inclusion of the MCE project (commissioned in 2022) into RAB.

**Commitment to the Rating:** We expect the company to reassess and possibly adjust its capital structure, in light of the rising uncertainties affecting a large part of the business. The rating action also takes into account the strong and explicit shareholders' commitment to 'BBB' rating and the possibility of quickly adjusting the company's capital structure under normal circumstances.

## Derivation Summary

eustream, a.s. (BBB+/RWN) is Net4gas's closest rated peer since both companies own and operate gas transit pipelines in Slovakia and Czech Republic, respectively, although Net4gas also benefits from a higher share of domestic business with more supportive regulation and almost zero exposure to short-term contracts, leading to a higher debt capacity. Both companies are highly dependent on Russian gas transit to Europe, with concentrated counterparty risk.

Net4gas is in a weaker competitive position than fully regulated national transmission system operator 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 long-term ship-or-pay contracts.

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 its dominant contribution of high-quality regulated activities.

## Key Assumptions

- Revenue is 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) to net asset value within RP5 and the inclusion of the MCE investments into RAB in 2022;
- No short-term or uncontracted bookings from 2022 onwards;
- Cost of new debt in line with current documentation;
- Cash tax rate at 20% of EBT, normalised for working capital swings;
- Decreasing annual capex to less than CZK1 billion from 2024 onwards from more than CZK5.5 billion in 2022;

## RATING SENSITIVITIES

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

We would affirm the rating if long-term business visibility was reinstated and the expected capital structure was sufficiently conservative based on the revised business profile.

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

Failure of Gazprom (or Net4Gas itself) to perform under the long-term take-or-pay contracts;

Evidence of a marked deterioration of the business profile, with a permanent loss of the long-term visibility not sufficiently compensated by a more conservative capital structure.

**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:** Net4gas's adequate liquidity is supported by the cash-generative nature of the gas transport business, leading to strong pre-dividend FCF generation and prudent equity-funding of large investments (ie C4G and MCE).

With the refinancing of the maturing bonds in early 2021, the company has significantly improved its debt maturity profile with no debt maturing till 2025.

Given the lack of refinancing needs, Net4gas does not detain undrawn committed credit line, but only a CZK0.5 billion overdraft currently drawn and approximately CZK2.0 billion of cash and cash equivalent.

**Issuer Profile**

Net4gas is a gas transmission system operator whose complex set of pipelines is situated on the transit route of gas from Russia to Western Europe. The company operates over 3,970km of pipelines, three border transfer stations and five compressor stations. Domestic regulated transportation business accounts for about 20% of total EBITDA, while the remaining 80% is almost fully related to long-term contracted international gas transit business.

**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](http://www.fitchratings.com/esg)

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## Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
NET4GAS, s.r.o.	LT IDR	BBB 	Rating Watch On	BBB 
• senior unsecured	LT	BBB 	Rating Watch On	BBB

## RATINGS KEY OUTLOOK WATCH

POSITIVE



NEGATIVE



EVOLVING



STABLE



## Applicable Criteria

[Corporate Rating Criteria \(pub.15 Oct 2021\) \(including rating assumption sensitivity\)](#)

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

[Country-Specific Treatment of Recovery Ratings Criteria \(pub.05 Jan 2021\)](#)

## 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

### Solicitation Status

## Endorsement Status

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

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