



RATING ACTION COMMENTARY

Fitch Downgrades Net4gas to 'BB+'; Maintains RWN

Tue 10 May, 2022 - 12:04 ET

Fitch Ratings - Milan - 10 May 2022: Fitch Ratings has downgraded Net4gas, s.r.o.'s Long-Term Issuer Default Rating (IDR) and senior unsecured rating to 'BB+' from 'BBB' and maintained them on Rating Watch Negative (RWN).

The downgrade reflects our view of substantially higher risk to Net4gas' long-term ship-or-pay contracts with Gazprom, in combination with the current level of indebtedness and the deterioration of the key counterparty's credit quality.

Our view is derived from the progressive escalation of sanctions between Europe and Russia, which could prevent the receipt of scheduled payments from Gazprom in case of further measures, and from Europe's firm commitment to strongly reduce their reliance on Russian gas. While Net4gas' infrastructure could accommodate alternative flows, and thus receive capacity bookings also to service eastern Europe in the medium term, visibility on this is currently limited. Net4gas maintains strong liquidity and options for counter-measures in case of adverse development in its transit business.

The RWN reflects the material risk of non-payment from Gazprom, potentially stemming from a complete halt of gas flows from Russia to the EU. We would affirm the rating with a Stable Outlook if such risk eases or if medium-term cash flow visibility improves, potentially as a consequence of easing geopolitical tensions. The RWN resolution could take longer than six months.

KEY RATING DRIVERS

Long-Term Contracts at Risk: We see increasing risk to the long-term ship-or-pay transit contracts between Net4gas and Gazprom, which account for around 75% of the company's revenue, due to potential further escalation of sanctions and deteriorating underlying gas transit fundamentals. EU has announced a clear commitment to diversify gas supply, reduce and, ultimately, eliminate its energy dependence on Russia. We acknowledge the capacity-based nature of Net4gas contracts with Gazprom; however, we believe that the increasing gap between expected gas flows and long-term booked transit capacity poses a serious threat to the company's otherwise strong revenue visibility.

Performing Contracts, Weaker Counterparty: At present the EU sanctions and Russia's responses have not halted gas flows to its largest end-markets in Europe or Gazprom's ability to pay under its ship-or-pay contracts, allowing Net4gas to perform better-than-expected, while accumulating CZK4.7 billion of cash on its balance sheet as of April 2022.

Assuming an ordinary flow of payments from Gazprom in the medium term, and in the absence of dividend distributions, Net4gas would reduce net debt to around 2x funds from operations (FFO) in 2026 from 4.0x in 2021, which would represent rating upside. However, Gazprom's counterparty risk is now increased since the conflict, weighing on Net4gas' creditworthiness.

Highly Uncertain Environment: The downgrade also reflects the risk that escalating sanctions could lead to a complete cut off of Russian gas to Europe and possibly one or both parties being unable to honour the ship-or-pay contract. In case of Gazprom's non-payments, funds from operations (FFO) net leverage would jump to above 10x and debt reduction capacity would be limited, all else being equal. We expect Net4gas to be entitled to claim some compensation from public authorities, if halted payments are triggered by EU sanctions, but visibility on the overall compensation process is very limited, in our view.

Medium-Term Uncertainty: The increasing gap between expected gas flows from Russia and long-term booked capacity in the medium term may also increase the likelihood that major shipper could attempt to challenge the contracts. While we believe Net4gas would insist on its strong legal contractual rights in this scenario, cash flow visibility, in our view, would be reduced.

Limited Visibility on Alternative Flows: We believe that Net4gas's infrastructure, aside from serving as the regulated national transmission system operator (TSO) (expected around CZK2.2 billion in annual revenue) and residual transits related to Nord Stream, will continue to play a key role in allowing central and eastern European (CEE) countries' gas imports, even in absence of Russian gas. However, any estimate of alternative gas

flows and contractual visibility (ie short- or long-term bookings) would depend on the final shape of the European gas market, which is highly uncertain at present.

Challenged Capital Structure: A failure to pay by Net4gas's major shipper, or a potential contractual dispute, would require, in our view, a material rebalance of the capital structure, which currently includes around CZK34 billion financial debt. We view both Allianz Capital Partners and OMERS as disciplined shareholders (dividends are currently suspended until "the risk of an external shock materialising has significantly reduced") and expect them to avoid distributions in a highly uncertain environment. However, the visibility of support under extreme scenarios is now understandably low. Once business visibility is largely restored, we expect the company and its shareholders to adhere to the original target of an investment-grade capital structure, which we see as achievable.

DERIVATION SUMMARY

eustream, a.s. (BBB+/RWN; 'bbb' Standalone Credit Profile recently revised from 'a-') is Net4gas's closest rated peer since both companies own and operate gas transit pipelines in Slovakia and the 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. Both companies are highly dependent on Russian gas transit to Europe, with concentrated counterparty risk while eustream's balance sheet is significantly less leveraged (around 2.5x FFO net leverage)

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 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 the dominant contribution of high-quality regulated activities.

KEY ASSUMPTIONS

- Revenue is based on the current regulatory framework for 2022-2025 (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 in RAB in 2022

- For the transit business, we conservatively assume lower revenue compared with the ship-or-pay contract, to factor in the reduced visibility related to sanctions and high geopolitical tensions
- No additional short-term bookings from 2023 onwards
- Transit operating expenditure reduced by 30%-35% from 2023 onwards, reflecting estimated potential rationalisation opportunities
- Cumulative capex reduced by more than CZK1.3 billion in 2022-2026, reflecting estimated potential rationalisation opportunities
- No dividend payments during 2022-2026

RATING SENSITIVITIES

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

- We would affirm the rating and remove it from RWN if long-term business visibility and operating environment improve or if the shareholders further tangibly demonstrate their intention to support the company

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

- Sudden and near-complete cut of Russian gas supply to EU could lead to a negative rating action, as it would materially increase the risk of non-payment under ship-or-pay contracts in our view
- Failure of Gazprom (or Net4gas itself) to fulfil their long-term contracts obligations could imply a multi-notch downgrade
- Evidence of further significant deterioration of the business profile, with a permanent loss of a large part current transit income not replaced by alternative medium-to-long-term bookings or 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 its gas transport business, leading to positive pre-dividend FCF generation, and by first debt maturities only in 2025 (around CZK10 billion) and 2026 (around CZK5 billion). We estimate that the company can repay through available cash and operating cashflows its 2025 and 2026 debt maturity in our revised case.

Net4gas does not have undrawn committed credit lines, but at end-April it had around CZK4.7 billion of cash and cash equivalent.

ISSUER PROFILE

Net4gas is a gas TSO whose complex set of pipelines is situated on the transit route of gas from Russia to western Europe. Historically the domestic regulated transportation business accounts for about 25% of total revenues, while the remaining 75% is almost fully related to its 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

RATING ACTIONS

ENTITY / DEBT ↕

RATING ↕

PRIOR ↕

NET4GAS, s.r.o.	LT IDR	BB+ Rating Watch Negative	BBB Rating Watch Negative
	Downgrade		
senior unsecured	LT	BB+ Rating Watch Negative	BBB Rating Watch Negative
	Downgrade		

[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

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NET4GAS, s.r.o.

EU Issued, UK Endorsed

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