FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Net4Gas's IDR to 'BB', Unsecured Notes to 'BB+'; off RWP; on Positive Outlook

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Fitch Ratings - Milan - 05 Jan 2024: Fitch Ratings has upgraded NET4GAS, s.r.o.'s Long-Term Issuer Default Rating (IDR) to 'BB' from 'BB-' and its senior unsecured rating to 'BB+'/ from 'BB-'. Its Recovery Rating has been revised to 'RR2' from RR4'. We have removed the ratings from Rating Watch Positive (RWP). The Outlook on the Long-Term IDR is Positive. A full list of rating actions is below.

The upgrade of the IDR mainly reflects the supportive regulatory developments in the recent 2024 regulatory price decision, which we believe will almost double gas transportation revenues compared with 2023, while prospects for the international gas transit business remain depressed. This supports NET4GAS's Standalone Credit Profile (SCP), which we view as having shifted to a predominantly regulated gas transmission system operator (TSO), and improves recovery prospects for senior unsecured creditors. This leads to a notch of uplift for the senior unsecured instruments.

The Positive Outlook reflects the likelihood of support from stronger parent CEPS, a.s. (and indirectly the Czech government) following the completion of its acquisition of NET4GAS. However, we are yet to form a final view on the magnitude of legal, operational and strategic incentives for CEPS to support NET4GAS under our Parent and Subsidiary Linkage Rating Criteria (PSL).

KEY RATING DRIVERS

Supportive Tariff Decision: We estimate that the 2024 tariff decisions will materially increase NET4GAS's allowed regulatory revenues to around CZK4.2 billion, higher than our prior expectation (CZK3.2 billion) and the CZK2.2 billion expected for 2023. This demonstrates the supportive attitude of the Czech regulator (ERO), which constructively reacted to the unprecedented changes in gas flows by accounting for the security of supply from NET4GAS's dual-use (internal and transit) infrastructure.

Limited Transit Prospects: We estimate low revenue contribution from international gas transit bookings for NET4GAS, at no more than CZK500 million-CZK1.0 billion annually. There are limited upsides as Russian gas continues to flow to Central and Eastern Europe via Ukraine and Turkish stream routes.

Evolution Towards A Regulated TSO: NET4GAS's business is moving towards that of a regulated gas TSO, where short-term international transit is likely to represent close to 20% of the company's revenues. This will significantly improve the visibility of its operating cash flow and support its debt capacity. On the other hand, 2023 and prospective EBITDA has been more than halved from the CZK7.3 billion annual expectations before Russia's invasion of Ukraine.

Updated Projections: We project EBITDA at around CZK1.8 billion in 2023 (2022: CZK11.3 billion), due to limited transit activity, and negative free cash flow (FCF) slightly higher than CZK1 billion. This results in double-digit funds from operations (FFO) net leverage in 2023, before it progressively declines towards 7.0x in 2025 (7.5x in our prior estimates), as EBITDA normalises at slightly more than CZK3.45 billion (CZK3.0 billion in our prior estimates) and with positive annual FCF estimated at more than CZK1.7 billion (we assume no dividends). Similarly, stretched FFO interest coverage of 1.1x in 2023 is expected to improve towards 2.5x, which would be aligned with a 'BB' rating.

Senior Unsecured Rating Uplift: Under our methodology, NET4GAS's senior unsecured rating benefits from a one-notch uplift from the IDR, due to the significantly increased and predominant contribution of regulated activities to group EBITDA.

Parent-link Upside Unclear: Fitch expects the stronger credit profile of fully state-owned CEPS will likely have a positive influence on NET4GAS's ratings, now that the acquisition is complete. We are yet to form a final view on the links between the companies and assess the magnitude of CEPS's legal, operational and strategic incentives to support NET4GAS's credit profile. The group's prospective financial strategy and their legal links (such as permanent cross-default provision, if any) will be a key input for our analysis.

DERIVATION SUMMARY

Following the shift towards a predominantly regulated gas transmission system operator (TSO), NET4GAS' closest peer is the large Czech gas distributor Czech Gas Networks Investments S.a r.l (CGNI; BBB/Stable), since they share the same operating environment, regulator and supportive regulations. On the other hand, Fitch sees higher debt capacity for CGNI (6.7x negative sensitivity at BBB level), mainly in light of its lack of exposure to unregulated businesses compared with 20% of NET4GAS represented by short term ship-or-pay gas transit contracts. CGNI's higher rating is also underpinned by current more conservative capital structure.

Compared with central and eastern European gas distributor peer, SPP - distribucia, a.s. (SPPD; A-/Stable; SCP of a), NET4GAS maintains similar debt capacity, benefiting from more mature regulations counterbalancing its unregulated exposure to international transit business. However, SPPD's conservative capital structure with average FFO net leverage below 3.0x mostly explains the rating differential in terms of SCP. SPPD's IDR is capped at one notch above the consolidated credit profile of its immediate parent, SPP Infrastructure, a.s. (SPPI), in line with our PSL Criteria.

Notwithstanding a more advanced business transition towards a pure regulated gas TSO, the Romanian SNTGN Transgaz SA (BBB-/Stable) has a less defensive business profile than NET4GAS. This stems from the significant cash flow volatility, resulting mainly from large regulatory correction adjustments. However, expected FFO net leverage is much more conservative averaging around 4.0x, explaining the rating differential.

KEY ASSUMPTIONS

-TSO revenues based on the current regulatory framework, the 2024 price decision, and the 2025 consultation paper of the network code for harmonised transmission tariff structures (NC TAR)

-International gas transit contributing in between CZK500 million and CZK1 billion revenues per year

-Annual operating expenditure of CZK1.2 billion, including some cost rationalisation

- Working-capital absorption of CZK400 million in 2023, neutral working capital over 2024-2026

-Cumulative capex of CZK3.7 billion in 2023-2026 (on a decreasing trend), including some spending cuts

-Full repayment of 2025 debt maturity

-No dividend payments

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Positive assessment of available legal, strategic and operational incentives to support from CEPS (or indirectly the Czech government) under our PSL Criteria

-Further materially positive regulatory developments (including more long-term visibility)

-FFO net leverage below 7.0x and FFO interest coverage above 2.5x, with a business mix of about 70%-80% of EBITDA from regulated activities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-Negative regulatory updates for the domestic gas transport business amid continuously weak alternative gas transit

-FFO net leverage above 7.7x, and FFO interest coverage below 2.0x with a business mix of about 70%-80% of EBITDA from regulated activities

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Cash on balance sheet was around CZK5.7 billion at end-August 2023. This is sufficient to cover remaining 2023 and 2024 operating expenses (of about CZK1.2 billion a year), financial charges (about CZK1.5 billion a year) and expected capex (cumulatively below CZK1 billion). We expect the first significant debt maturity only from mid-2025 at almost CZK10 billion.

ISSUER PROFILE

NET4GAS is the Czech Republic's national gas TSO, and provides the infrastructure for gas transit to central European markets. With bi-directional flow capacity, NET4GAS operates a large-scale high-pressure gas transmission and transit system of 4,058 km 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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
NET4GAS, s.r.o.	LT IDR	BB Rating Outlook Positive	Upgrade		BB- Rating Watch Positive
senior unsecured	LT	BB+	Upgrade	RR2	BB- Rating Watch Positive

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country-Specific Treatment of Recovery Ratings Criteria (pub. 03 Mar 2023)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Exposure Draft: Government-Related Entities Rating Criteria (pub. 15 Sep 2023)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 03 Nov 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (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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