FITCH AFFIRMS NET4GAS AT 'BBB'; OUTLOOK REVISED TO STABLE

Fitch Ratings-London-27 June 2016: Fitch Ratings, London, 27 June 2016: Fitch Ratings has affirmed NET4GAS, s.r.o.'s Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is revised to Stable from Positive.

The Outlook revision to Stable reflects our updated guidelines for the rating in anticipation of an increasing share of earnings coming from short-term capacity bookings, due to several long-term contracts expiring during the next five years. The shareholder loan redemption is neutral for the rating in our view.

The rating affirmation is supported by NET4GAS's strong business profile as the sole national gas transmission system owner and operator (TSO) in the Czech Republic, its long-term ship-or-pay transit contracts for Russian gas to Europe with limited exposure to the route across Ukraine, and by the favourable three-year regulatory determination for its domestic regulated business which started in 2016.

KEY RATING DRIVERS

Tighter Rating Sensitivities
Fitch expects an increasing share of NET4GAS's transit earnings to come from short-term (ST) contracts, especially after 2020. As anticipated in our Rating Action Commentary on 27 July 2015, Fitch has therefore tightened the leverage guidelines for a positive rating action by 0.55x. The company outperformed our previous expectations and the final regulatory determination for the domestic transmission business also supports credit metrics. The Stable Outlook reflects our expectation that although funds from operations (FFO) net adjusted leverage is likely to remain solid for the rating, excluding the capex spike during 2017 and 2018, it no longer supports an upgrade.
We will continue to assess any business risk impacts derived from the contractual terms and evolution of counterparty exposure as new projects are commissioned, especially if additional transit capacity is booked on a long-term basis to support the proposed Nord Stream 2 project. We expect possible cash-flow upside to largely benefit shareholders through increased dividends to the extent that credit metrics remain commensurate with a 'BBB' rating.

Shareholder Loan Redemption Rating Neutral
Fitch forecasts slightly higher leverage metrics with its peak in 2017 at 5.7x (5.2x on average throughout the rating horizon of 2016-2021) due to the expected redemption of a CZK11bn shareholder loan in 2016, half of which will be injected as equity, followed by a further equity injection of over CZK7bn towards the Czech-Polish Interconnector (CPI) investment from 2018 to 2020. We believe the increase in leverage will be temporary and due to the difference in timing of the equity injections. The overall trend of leverage metrics will still comfortably sit within our revised rating sensitivity for the 'BBB' IDR. Higher equity will also provide a buffer for net income volatility, reflecting (non-cash) FX swap valuation changes.

Long-Term Contract Expiry
Four long-term contracts will mature during our rating horizon (2016-2021) and they are unlikely to be renewed in our view, especially the one on the traditional East-West route. However, Fitch expects some of the reverse gas flows (West-East) will be sustained on a uncontracted/short-term contract basis given that there are no alternative routes to deliver gas to Slovakia then to Italy and

Ukraine (Exit Lanzhot). In our projections, we have assumed sustained gas flows in the West-East direction at a conservative level.

Final Determination Rating Positive
Domestic transmission regulatory parameters set for the regulatory period (RP4) in 2016-2018 are favourable, notably with pre-tax nominal weighted-average cost of capital (WACC) at 7.94%, fixed for the entire RP4. Historically, volatile WACC has been a rating risk in our view. We assume that the expected increase in capex for 2018-2020 will increase the regulatory asset base, or earn remuneration without volume risk. We continue to expect positive free cash flow except during the investment spike in 2017 and 2018.

Refocused Transit Business
We expect NET4GAS's transit business, representing around 80% of its revenues, to remain the company's key cash-flow driver. Since 2013, around 85% of its long-term booked capacity is in north-south or west-east directions, limiting its exposure to the traditional east-west route across Ukraine.

Concentration of Contracts
Significant counterparty concentration is a risk for NET4GAS, reflecting the company's direct exposure to Gazprom (BBB-/Negative) as the largest counterparty. This does not represent a constraint for the ratings due to the historical performance under the contracts, the higher unconstrained credit profile of the counterparty and the continued importance of the NET4GAS route in reaching the shippers' ultimate customers and source of cash flows.

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.

FX Exposure
Much of the transit capacity is contracted in US dollars, followed by Czech koruna (which is also the currency for the domestic business) and euros. In total, including domestic transport and transit businesses, the company receives more than half of its revenue in Czech koruna followed by US dollars and euros. Costs are largely in koruna with some capex in foreign currency. NET4GAS targets cash flow hedge of FX using debt issued across the currencies and cross currency swaps. However, balance-sheet ratios and net income are impacted by currency fluctuations.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for NET4GAS include:
- Regulatory returns in line with the determination for RP4, including WACC fixed at 7.94%.
- Short-term bookings of 28 GWh/day annually for 2017-2019 and 355 GWh/day annually for 2020-2021.
- Partial utilisation of long-term contracts.
- Refinancing at 4% versus overall cost of debt of 3.1% and recent placement at 2.8%.
- Capex at around CZK12.5bn for 2016-2021 including the Czech-Polish interconnector.
- Flexible dividend policy.

RATING SENSITIVITIES
Positive: Future developments that may, individually or collectively, lead to an upgrade:
- 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.

Negative: Future developments that may, individually or collectively, lead to negative rating action include:

- Projected FFO net adjusted leverage at above 5.2x and FFO interest coverage at below 2.5x on a sustained basis.
- Adverse change in NET4GAS's contract portfolio or failure of counterparties to perform under the contracts.
- Significant weakening of the unconstrained credit profile and increase in exposure to NET4GAS' key counterparty.
- A deterioration in the domestic regulatory environment for gas transmission.

LIQUIDITY
NET4GAS's liquidity is supported by a currently undrawn EUR100m (around CZK2.7bn) revolving capex facility, which can be utilised in euros, dollars or koruna, and strong pre-dividend FCF supported by its cash generative nature of business. The shareholders are prudent in their dividend policy with a clear intention of maintaining a strong investment-grade rating. There is no restricted cash on the balance sheet and we have included only the deposits with maturities less than three months in our analysis.

Contact:

Principal Analyst
Hugh Shim
Analyst
+44 20 3530 1724

Supervisory Analyst
Ana Gaspar
Associate Director
+44 20 3530 1601
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson
Arkadiusz Wicik
Senior Director
+48 22 338 62 86

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362