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Research Update:

Czech Gas Transmission Company NET4GAS 'BBB' Ratings Affirmed; Outlook Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

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Overview

- NET4GAS continues to perform strongly against our base-case expectations.
- However, we anticipate that NET4GAS' contract base will become less predictable because the proportion of short-term contracts in total revenue will increase from 2020. We therefore now consider adjusted funds from operations to debt of 18% commensurate with the rating.
- We are affirming our 'BBB' long-term rating on the company.
- The stable outlook reflects our expectation that NET4GAS will maintain its stable and strong cash flows from ship-or-pay contracts over the rating horizon despite a short-term dip in ratios resulting from its plan for high capital expenditures.

Rating Action

On June 3, 2016, S&P Global Ratings affirmed its 'BBB' long-term corporate credit rating on Czech gas transmission and transit grid operator NET4GAS s.r.o. (NET4GAS). The outlook is stable. We also affirmed the 'BBB' rating on NET4GAS' senior unsecured debt.

Rationale

NET4GAS continues to perform strongly against our base-case expectations. The company's strong business risk profile is underpinned by the stable and predictable cash flows from ship-or-pay contracts in the transit business, which account for about 80% of revenues, and from its regulated gas transmission operations in the Czech Republic, which offer low volatility of earnings and above-average profitability. That said, we understand that, from 2020 when the major part of its ship-or-pay transit contracts are due to expire, NET4GAS' contract portfolio will be composed of an increased share of short-term bookings. This could potentially increase the volatility of cash flow generation and pressure profitability. In addition, we consider that NET4GAS' customer concentration to Gazprom--a large Russian gas producer, exporter, and government-related entity--is a key risk because we estimate that Gazprom contributes about 56% of NET4GAS' revenues. However, the relationship remains stable and supported by long-term ship-or-pay contracts. The route via the Czech Republic is critical for the delivery of Russian gas to European consumers.

In our view, NET4GAS' significant financial risk profile is underpinned by relatively stable funds from operations (FFO) to debt. Most of NET4GAS' income

comes from ship-or-pay contracts, which we consider offer greater stability given their lower volume risk and greater revenue certainty; however, some contracts mature in 2017, 2019, and 2020. NET4GAS' financial profile will also be constrained over the next three to four years by a large capital expenditure (capex) program of about Czech koruna (CZK) 11 billion, mainly driven by the construction of a Czech-Polish Interconnector pipeline.

Given this expectation of future potential additional volatility, we now consider an adjusted FFO-to-debt ratio of 18% on a sustainable basis is commensurate with the rating, compared with 15% previously. Our current assessment of NET4GAS' significant financial risk nevertheless acknowledges that this ratio will be subject to a temporary decline to 16% in 2017-2018 on the back of intensive capex plans.

In our base case, we assume:

- Transit revenues based on existing long-term contracts only, and a conservative approach to short-term bookings;
- Domestic transmission revenues based on the existing regulatory period to end-2018;
- Capex of CZK710 million in 2016; and
- Shareholder loans treated as 100% equity.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt of 21% in 2016 and of about 16% in 2017-2018, increasing to more than 18% thereafter; and
- Debt to EBITDA of 3.7x in 2016 and 4.4x-4.7x in 2017-2018.

Liquidity

We assess NET4GAS' liquidity position as strong, as we expect its ratio of sources to uses of funds will be at least 1.5x over 2016 and at least 1x over 2017. We consider that NET4GAS conservatively manages interest rate currency risk by using a combination of swaps and natural hedges. NET4GAS' debt does not have any financial covenants.

The company's liquidity sources, as of March 31, 2016, comprise:

- Unrestricted cash of about CZK2.2 billion;
- FFO that we estimate at about CZK5,400 million in 2016; and
- An undrawn committed revolving credit facility of €100 million, expiring in 2019.

We anticipate that cash outflows for 2016 will include:

- Capex of about CZK1,270 million; and
- dividends of about CZK2,700 million (including interest paid on the shareholder loan).

Outlook

The stable outlook reflects our opinion that the ratings on NET4GAS will continue to be supported by stable gas transit demand, a supportive regulatory environment, and successful delivery of its capital projects, which will

benefit from compensation arrangements with the Czech Republic energy regulator.

Downside scenario

We would consider a downgrade if the adjusted FFO-to-debt ratio does not sustainably increase above 18% by 2019-2020 after a temporary deterioration of FFO to debt of about 16% in 2017-2018. We could also lower the rating if the volatility of earnings or level of EBITDA margins changed significantly. This could occur, for example, as a result of changes to the regulatory regime, increased volatility stemming from the greater proportion of short-term contracts in the revenue base, unexpected operational problems, nonpayment from counterparties, or higher operating expenses or capex than we currently anticipate.

Upside scenario

We may consider an upgrade if NET4GAS' sustained credit metrics of FFO to debt above 23%, successfully completed its capex program on time and within budget, and relationships with key customers remain stable.

Ratings Score Snapshot

Corporate credit rating: BBB/Stable/--

Business risk: Strong

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Strong

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- Criteria - Corporates - General: The Treatment Of Non-Common Equity

Financing In Nonfinancial Corporate Entities - April 29, 2014

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry - December 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Ratings List

Ratings Affirmed

NET4GAS s.r.o.

Corporate Credit Rating	BBB/Stable/--
Senior Unsecured	BBB

Additional Contact:

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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