S&P Global Ratings

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NET4GAS s.r.o.

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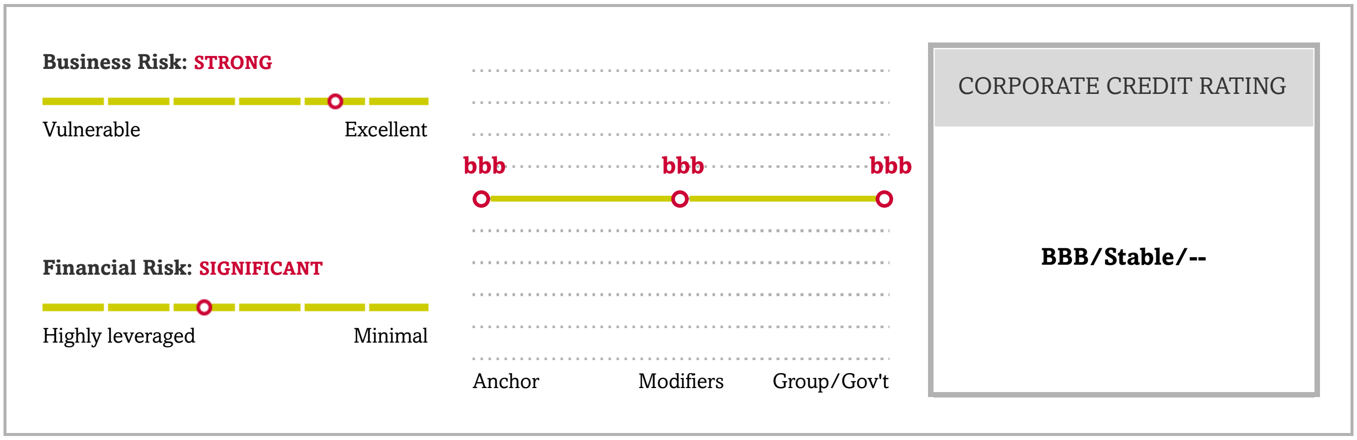

Rationale

Business Risk: Strong	Financial Risk: Significant
• Stable and strong cash flows from regulated gas transmission operations in the Czech Republic and from ship-or-pay contracts covering the gas transit business. • Well-established and credit-supportive regulatory framework for gas transmission, with next regulatory reset risk in 2019. • Fully reversible transit system, making NET4GAS resilient to changing gas flow patterns. • Some risk from consumer concentration, with about 60% of revenue derived from Gazprom. • Risk of increased competition from other gas pipeline companies and routes over the medium- to long-term. • Political risk associated with the implementation of the Nord Stream 2 pipeline and consequently with the implementation of Capacity4Gas project, which would weigh on contracted revenues.	• Relatively stable cash flows from gas transportation operations with funds from operations (FFO) to debt sustainably at around 18%-20%. • Strong liquidity supported by large cash balances. • Commitment of strategic shareholders to maintain debt leverage in line with our thresholds for the current rating. • Large capital expenditure (capex) program of CZK25 billion (€950 million) over the next five years, which we expect to be funded predominantly by equity. • Aggressive, but potentially flexible, dividend payout 100% of net income.

Outlook: Stable

The stable outlook reflects S&P Global Ratings' opinion that NET4GAS will continue to be supported by stable gas transit demand in Europe and a portfolio of long-term ship-or-pay supply contracts, a supportive regulatory environment, and successful delivery of its capital projects.

Downside scenario

We would consider a downgrade if the adjusted FFO-to-debt ratio does not sustainably increase above 18% by 2018-2019 after a temporary deterioration of FFO to debt of about 16% in 2017.

We believe the shareholders are supportive and committed to maintain the current rating, but we could change our view and consider a downgrade if we saw signs of weakening support. For example, a change in the company's capex funding strategy and respective increase in leverage, in our view, would point to a shift in the shareholders' approach.

We could also lower the rating if the volatility of earnings or level of EBITDA margins changed significantly. This could occur, for instance, as a result of adjustments 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 FFO to debt above 23%, successfully completed its capex program on time and within budget, and maintained stable relationships with key customers.

Our Base-Case Scenario

Assumptions	Key Metrics
• Anticipated reduction in revenues in 2017 by 15%-20% against 2016 related to maturing old ship-or-pay contracts and nearly flat revenues in 2018 though may be compensated by revenues from short-term transit bookings leading to potential additional volatility, in our view. • Stable regulated domestic transmission revenues based on the existing regulatory period to end-2018. • Additional capex needs of €540 million/Czech koruna (CZK) 14.5 billion in 2017-2021 related to C4G project, which we expect to be funded by equity injections. • Total annual capex of approximately CZK900 million in 2017 and about CZK3 billion in 2018, including C4G and CPI. • No additional debt. CZK7.1 billion bank borrowings maturing in 2018 already refinanced. • Dividend of CZK3 billion in 2017 and nil in 2018, according to shareholders' expectations	• FFO to debt of at least 16% in 2017, before recovering to more than 18% in 2018-2019; and • Debt to EBITDA between 4.0x-4.6x over 2017-2019.

Company Description

NET4GAS holds an exclusive license for gas transmission in the territory of the Czech Republic. It operates a pipeline network for national transmission of natural gas (regulated operations, about 20% of revenue) and international transit (about 80% of revenue) with a total length of more than 3,800 km. Its gas transmission system is interconnected with major gas pipelines in Germany, the Slovak Republic, and Poland.

Total gas volumes transported in 2016 amounted 43.9 bcm. Of this, 8.3 bcm where consumed by the Czech Republic.

Business Risk: Strong

We continue to see that NET4GAS's strong business risk is supported by the stable and predictable cash flows from ship-or-pay contracts in the transit business, which account for about 80% of revenues and nearly the same share of EBITDA, and from its regulated gas transmission operations in the Czech Republic, which offer low volatility of earnings.

We believe that NET4GAS benefits from the flexibility of a fully reversible transit system--that is, well located pipelines--that forms a key part of the gas transit path for supply consumers in Southern and Eastern Europe.

However, we believe that NET4GAS' customer concentration with Gazprom--which is a large Russian gas producer, exporter and government-related entity--is a key risk because we estimate that currently Gazprom contributes to about

60% of NET4GAS' revenues and will increase to about 70% once Capacity4Gas (C4G, see below) is commissioned. That said, the relationship has remained very stable so far and supported by long-term ship-or-pay contracts. The route is critical for the delivery of Russian gas to European consumers in the light of decreasing volumes supplied through Ukraine. Still, we see potential competition from other gas pipelines and transit routes and regulatory reset usually every five years as other risks.

In late 2016 The Energy Regulatory Office (ERO, an administrative authority responsible for regulation in the energy sector) decided to reduce price cap for international transit by 20% according to current market conditions. At the same time, a fixed-price approach was reintroduced for long-term bookings, meaning that new contracts are based on a fixed initial price that will be updated annually in line with the consumer price index. These changes are only applicable to new contracts (including C4G) and do not impact projected revenues under old contracts.

Net4Gas is currently undergoing two main projects: C4G and Czech-Polish Interconnector (CPI).

Net4Gas will start in 2017 a €740 million (about CZK20 billion) construction of Capacity4Gas project, out of which €540 million to be invested until 2021. It will link German EUGAL, at a new interconnection point Brandov / Hora Svate Kateriny, to Slovakian eustream transmission system, at an interconnection point Lanzhot. 80%-90% of future cross-border capacities related to this pipeline were auctioned to Gazprom Export, providing new contracted revenues in 2020-2039.

Thereby, with this new ship-or-pay transit contract, NET4GAS' contract portfolio will be composed primarily of long-term predictable bookings. This, in our view, should support lower volatility of cash flow generation and profitability from 2020.

We understand that this project carries some political uncertainty and details are expected to become clearer in 2019. We believe that risks for the company linked to potential C4G abandonment are limited according to the terms of contract on provision of gas transmission service to Gazprom Export, which would reimburse Net4Gas for reasonably incurred expenses. That said, if the project was cancelled, Net4Gas would lose the enhanced diversity that the completed project would bring to the company.

In 2016 the timeline for new gas transit pipelines Stork II and Moravia, collectively the Czech-Polish Interconnector (CPI), has been revised. The project has been separated into two phases:

Moravian Loop, to be commissioned in 2021 vs 2019 originally planned (revenues of CZK 325 million per year to start in 2021); and

Full CPI project to be commissioned in 2023 (total CZK 400 million per year expected).

The CPI will be 70% equity funded and 30% debt funded to comply with CPI investment request that was a basis for regulatory decision on the project. These will connect to the Polish transmission system operator (TSO) and a new liquefied natural gas (LNG) terminal in Poland. We expect that the risks of delivering the project are mitigated by NET4GAS' management experience. We view as a positive that the pipeline's earnings will be partially guaranteed by regulatory tariffs set between the two countries.

Financial Risk: Significant

In our view, NET4GAS' significant financial risk is underpinned by relatively stable FFO to debt, at around 18% in the medium term.

We consider NET4GAS' shareholders, Allianz Group and Borealis Infrastructure, to be supportive strategic owners with a long-term investment horizon. We assume that they will continue to contribute equity to support the capex requirement of both CPI and the new C4G projects, which are expected to be fully commissioned starting 2021 and to start to contribute stable income to the company from then. This will support the company's performance metrics.

We believe that NET4GAS will pay out 100% of available net income as dividends. However, we consider the owners to be supportive, and that dividends will be adjusted, if necessary, to ensure that NET4GAS maintains credit ratios consistent with the current rating.

Financial summary

Table 1

NET4GAS s.r.o. -- Financial Summary					
Industry Sector: Gas					
	--Fiscal year ended Dec. 31--				
	2016	**2015**	**2014**	**2013**	**2012**
(Mil. CZK)					
Revenues	9,280.0	9,879.0	8,781.4	9,012.0	10,088.7
EBITDA	7,880.5	7,821.9	7,132.5	7,712.4	8,672.3
Funds from operations (FFO)	5,892.4	6,143.3	5,788.5	6,241.7	6,926.0
Net income from continuing operations	1,417.0	2,762.0	3,075.9	3,506.0	4,566.4
Cash flow from operations	5,745.4	5,750.3	6,197.0	5,771.1	7,028.7
Capital expenditures	728.0	584.0	703.8	629.5	3,919.5
Free operating cash flow	5,017.4	5,166.3	5,493.2	5,141.6	3,109.2
Discretionary cash flow	1,827.4	700.3	(1,998.1)	1,015.1	(1,641.8)
Cash and short-term investments	415.0	1,750.0	1,605.1	1,039.0	362.6
Debt	30,443.1	29,045.7	27,823.0	10,333.7	10,875.4
Equity	7,606.0	13,555.0	16,087.7	39,752.1	40,372.5
Adjusted ratios					
EBITDA margin (%)	84.9	79.2	81.2	85.6	86.0
Return on capital (%)	12.6	11.2	8.8	8.6	15.3
EBITDA interest coverage (x)	7.7	11.6	12.5	16.1	18.0
FFO cash int. cov. (x)	6.8	4.3	10.1	14.3	15.7
Debt/EBITDA (x)	3.9	3.7	3.9	1.3	1.3
FFO/debt (%)	19.4	21.2	20.8	60.4	63.7
Cash flow from operations/debt (%)	18.9	19.8	22.3	55.8	64.6
Free operating cash flow/debt (%)	16.5	17.8	19.7	49.8	28.6
Discretionary cash flow/debt (%)	6.0	2.4	(7.2)	9.8	(15.1)

CZK--Czech koruna.

Liquidity: Strong

We assess NET4GAS' liquidity position as strong, as we expect its ratio of sources to uses at about 2x over 2017 and at least 1x over 2018. 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.

Below, our estimate of the company's principal liquidity sources and uses for the 12 months started March 31, 2017.

Principal Liquidity Sources	Principal Liquidity Uses
• Unrestricted cash of about CZK 1,410 million; • FFO of about CZK4,922 million; • An undrawn committed revolving credit facility of €80 million and overdraft facility of €20 million (together about CZK2,702 million), expiring in May 2022; and • Equity injections of CZK668 million.	• Capex of about CZK1,418 million; • Dividends of about CZK3,000 million; • Working capital needs of about CZK400 million; and • No upcoming maturities (nil in the next 12 months).

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)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Reconciliation

Table 2

Reconciliation Of NET4GAS s.r.o. Reported Amounts With S&P Global Ratings (Mil. CZK)

	--Fiscal year ended Dec. 31, 2016--					
NET4GAS s.r.o. reported amounts						
	Debt	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**
Reported	28,047.0	7,836.0	5,756.0	1,016.0	7,836.0	5,701.0
S&P Global Ratings' adjustments						
Interest expense (reported)	--	--	--	--	(1,016.0)	--
Interest income (reported)	--	--	--	--	7.0	--
Current tax expense (reported)	--	--	--	--	(976.0)	--
Operating leases	41.1	47.5	3.1	3.1	44.4	44.4
Surplus cash	(415.0)	--	--	--	--	--
Non-operating income (expense)	--	--	7.0	--	--	--
Debt - Foreign currency hedges	2,770.0	--	--	--	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	(3.0)	(3.0)	--	(3.0)	--
Total adjustments	2,396.1	44.5	7.1	3.1	(1,943.6)	44.4
S&P Global Ratings' adjusted amounts						
	Debt	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
Adjusted	30,443.1	7,880.5	5,763.1	1,019.1	5,892.4	5,745.4

CZK--Czech koruna.

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers,

Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	**bbb**	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of June 30, 2017)

NET4GAS s.r.o.	
Corporate Credit Rating	BBB/Stable/--
Senior Unsecured	BBB
Corporate Credit Ratings History	
25-Jul-2014	BBB/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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