FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms NET4GAS at 'BBB'; Outlook Stable

Fri 03 Dec, 2021 - 8:52 AM ET

Fitch Ratings - Milan - 03 Dec 2021: Fitch Ratings has affirmed NET4GAS, s.r.o.'s (N4G) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The affirmation of N4G's ratings reflects the company's solid operating cash flow stability broadly unaffected by the current gas market dynamic as well as its long-term visibility, attributable to the Gazelle and Capacity4Gas (C4G) ship-or-pay contracts with PJSC Gazprom (BBB/Stable). Furthermore, the domestic regulatory framework is supportive and transparent, currently granting full visibility up to 2025.

N4G's shareholders have a prudent approach to leverage, executing large equity injections in parallel to investments in the C4G and Moravian capacity-extension (MCE) projects. N4G has re-leveraged its capital structure in 2021 to 4.5x, but it is still well below its rating sensitivity, set at 5.5x funds from operations (FFO) net leverage.

KEY RATING DRIVERS

Early Capital Structure Re-leverage: At the beginning of 2021, N4G refinanced its maturities and increased its gross indebtedness up to its targeted level of about CZK35 billion. By end-2021, we expect net debt to increase by CZK 7.4 billion yoy mainly due to the significant shareholder distributions estimated at about CZK14.5 billion. We expect FFO net Leverage to average 5.2x throughout 2021-2026, remaining below our negative guideline (of 5.5x), with a reasonable headroom.

Record 2021 Performance; Mostly Provisional: Fitch expects 2021 to be another exceptionally positive year for N4G, with an EBITDA reaching almost CZK8.5 billion largely driven by the lower-than-expected fuel energy. However, the majority of this EBITDA outperformance will be returned to customers by 2023 at the latest.

Reliance on NSI and NSII Routes: The vast majority of N4G's long-term booked capacities are for Russian gas routed through Nord Stream I (NSI) and Nord Stream II (NSII), in the respective north-south (until 2035, Gazelle) or west-east directions (2039, C4G). Contractual ship-or-pay C4G is not dependent on NSII being commissioned. However, following the actual physical completion of the two links, the potential NSII commissioning in 2022 would fade away any residual risk of renegotiation arising from the mismatch between available capacity and the actual (lack of) gas flow.

Predictable, Cash-Generative Business: N4G's transport and transit businesses are highly cash generative, leading to a historical and projected EBITDA margin above 80%. In 2022-2026, EBITDA and FFO are expected to remain largely stable at an average of CZK7.4 billion and CZK5.5 billion, respectively, underpinned by a solid RP5 framework and stable contracted capacity above 60 billion cubic metres (bcm)/year.

Investments would spike in 2022 at CZK5.5 billion along with the commitments of the MCE project (extension of the gas transportation capacity in the Moravian territory) and would then progressively decrease to about its maintenance level of CZK 0.9 billion in 2024-2026, freeing up large pre-dividend free cash flow (FCF). However, we expect this to translate into higher dividends rather than deleverage.

Negligible Volume and Price Downside Risk: The currently reduced transit of Russian gas to the EU and the related volatility of wholesale gas prices do not imply a material risk for N4G. The company's earnings are highly visible due to the regulated nature of gas transport (TSO) revenue representing 20% of N4G's top line, as well as by the long-term ship-or-pay contracts, which account for almost 100% of gas transit revenue, since N4G does not materially resort to short-term bookings. The gas transport revenue and C4G's transit revenue are fully protected by a well-defined t+2 true-up mechanism.

Counterparty Concentration Risk: N4G's counterparty exposure to Gazprom does not constrain the ratings due to the historical performance of the counterparty under the contracts, its 'a-' Standalone Credit Profile (stronger than the IDR) and the continued importance of N4G's transit route in reaching shippers' ultimate customers.

After the full commissioning of C4G (January 2021), we expect Gazprom to contribute about 75% of N4G's revenue, and other large European utilities to contribute the rest of the transit revenue. All counterparties (including domestic) must meet the regulatory standard of the network code and payments are typically made in advance. Domestic regulation allows recovery of revenue deficits.

Supportive Fifth Regulatory Review: The Czech Republic's transparent and stable gas transportation regulation supports N4G's current long revenue visibility. The RP5 is covering 2021-2025, in broad continuity with the past, incorporating a decrease to 6.4% in the allowed real rate of return.

The newly introduced mechanism for full convergence of the regulated asset base (RAB) with net book value by 2025 would support N4G's "allowed profit". This would enable "allowed revenue" to progressively increase to about CZK2.3 billion in 2025 (up by 23% vs 2020), also considering the 95% inclusion of the MCE project (commissioned in 2022) into RAB.

Well-Balanced FX Exposure: Fitch expects an increasing share of transit revenue in Czech koruna, which is also the currency for the domestic transport business, as koruna-denominated C4G contracts ramp up. The new loan is also drawn in koruna in anticipation of a decreasing share of revenue in US dollars after 2021, linked to expiring transit contracts. In total, domestic transport and transit businesses generate almost 80% of N4G's revenue in koruna, followed by dollars. Costs are largely in koruna. N4G hedges potential FX-related cash flow fluctuations using debt issued in dollars and cross-currency swaps to maintain leverage neutrality to FX movements.

DERIVATION SUMMARY

eustream, a.s. (A-/Stable) is N4G's closest rated peer since both companies own and operate gas transit pipelines in Slovakia and Czech Republic, respectively, although N4G also benefits from a higher share of domestic business with more supportive regulation and almost nil exposure to short-term contracts, leading to a higher debt capacity. Both companies are highly dependent on the Russian gas transit to Europe, with concentrated counterparty risk. However, eustream operates at a significantly lower FFO net leverage of about 2.7x in our forecasts, hence the higher rating.

N4G 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 N4G, but its earnings from traditionally regulated networks allow for a higher debt capacity than long-term ship-or-pay contracts.

Furthermore, under current corporate rating methodology, ship-or-pay contracts do not intrinsically strengthen recovery prospects for senior creditors, and, therefore, do not allow N4G's senior unsecured debt to be notched up from the IDR, unlike that of Czech Gas Network Investment, given its dominant contribution of high-quality regulated activities

KEY ASSUMPTIONS

-Revenue is based on the current regulatory framework for 2021-2025 (RP5), which entails a weighted average cost of capital set at 6.43%, the alignment of RAB to net asset value within RP5 and the inclusion of the MCE investments into RAB in 2022;

-No short-term or uncontracted bookings from 2022 onwards;

-Average annual EBITDA of about CZK7.3 billion in 2022-2026;

-Cost of new debt in line with current documentation;

-Cash tax rate at 20% of EBT, normalised for working capital swings;

-Decreasing annual capex to less than CZK1 billion from 2024 onwards from more than CZK5.5 billion in 2022;

-Significant shareholder distributions in 2021 resulting in a moderate re-leverage of the capital structure;

-Thereafter, dividends to average CZK3.7 billion per year over 2022-2026;

RATING SENSITIVITIES

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

-Expected FFO net leverage below 4.7x on a sustained basis (exp 2021: 4.5x), supported by shareholders' commitment to a higher rating, and higher earnings from long-term ship-or-pay contracts with diversified counterparties and the domestic business.

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

-Projected FFO net leverage above 5.5x on a sustained basis

-Adverse change in N4G's contract portfolio or failure of counterparties to perform under the contracts

-Significant weakening of the credit profile and increase in exposure to its key counterparty

-Delay or extra-costs to the MCE project without adequate mitigation from lower dividends

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

Satisfactory liquidity: N4G's satisfactory liquidity is supported by the cash-generative nature of the gas transport business, leading to strong pre-dividend FCF generation and prudent equity-funding of large investments (ie C4G and MCE). With the refinancing of the maturing bonds early in 2021, the company has significantly improved its debt maturity profile with no debt maturing till 2025.

Given the lack of refinancing needs, the company has adjusted its level of liquidity cancelling its CZK 2.9 billion undrawn committed credit line and downsizing its readily-available cash to CZK 0.5 billion expected at December 2021. We expect the company to generate robust pre-dividend FCF generation (of CZK 2.1 billion on average in 2021-2023), which would allow the company to cover dividend payments without resorting to additional debt up until 2023.

ISSUER PROFILE

N4G is a gas transmission system operator whose complex set of pipelines is situated on the transit route of gas from Russia to Western Europe. It transmits about 45bcm of gas every year, out of which about 8bcm is for domestic consumption. The company operates over

3,970km of pipelines, three border transfer stations and five compressor stations. Domestic regulated transportation business accounts for about 20% of total EBITDA, while the remaining 80% is almost fully related to 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 BBB Rating Outlook Stable Affirmed	BBB Rating Outlook Stable
senior unsecured	LT BBB Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Nicolò Meroni
Director
Primary Rating Analyst
+39 02 879087 296
nicolo.meroni@fitchratings.com

Fitch Ratings Ireland Limited Sede Secondaria Italiana
Via Morigi, 6 Ingresso Via Privata Maria Teresa, 8 Milan 20123

Jaime Sierra
Analyst
Secondary Rating Analyst
+49 69 768076 275
jaime.sierrapuerta@fitchratings.com

Antonio Totaro
Senior Director
Committee Chairperson
+39 02 879087 297
antonio.totaro@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Stefano Bravi
Milan
+39 02 879087 281
stefano.bravi@fitchratings.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

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), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

NET4GAS, s.r.o.	EU Issued, UK Endorsed

DISCLAIMER

FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

READ LESS

COPYRIGHT

meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Corporate Finance Utilities and Power Europe Czech Republic