FitchRatings

Fitch Affirms NET4GAS at 'BBB'; Outlook Stable

Fitch Ratings - Milan - 29 November 2019:

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 'BBB' ratings reflect N4G's significantly higher operating cash flow with improved visibility expected, attributable to now contractually binding ship-or-pay capacity bookings on the Capacity4Gas (C4G) project, an onshore capacity to complement Nord Stream II (NSII), maturing domestic regulatory framework, highly cash generative nature of the business and consistent outperformance.

These positive elements are counterbalanced by the expected re-leverage through dividend maximisation. However, the shareholders remain supportive of a credit profile consistent with the current rating with committed equity injections for the C4G and 70% of the Czech-Polish Interconnector (CPI) investments. The C4G project also exacerbates N4G's counterparty concentration risk.

Key Rating Drivers

C4G Rating Neutral: Fitch views the additional earnings from C4G capacity bookings (up to 40 bcm/a) as rating neutral as we anticipate they will be largely offset by equally higher dividend outflow and exacerbated counterparty concentration risk with PJSC Gazprom (BBB/Stable). Nonetheless, Fitch believes that the significant improvement in cash flow visibility and the enlarged transit portfolio increases the company's debt capacity. We have therefore loosened our leverage guideline for negative rating action by 0.3x to 5.5x.

Large Reliance on NSI and NSII: The vast majority of N4G's long-term booked capacities are for Russian gas through NSI and NSII, in the directions of west-east or north-west. Newly confirmed 20-year contracts for C4G will provide significantly higher and more predictable operating cash flow for N4G from 2020 than our previous forecast, regardless of the NSII commissioning, which is unlikely before 2H20, in our view. The withdrawal option for Gazprom on the C4G contracts expired in August 2019. N4G plans to complete two-thirds of 40bcm capacity by end-2019 and the rest by end-2020. We believe the transit contracts on the traditional east-west route across Ukraine are unlikely to be renewed after the last remaining contract expires in 2022.

Expected Re-leveraging up to Sensitivity: Net4Gas's businesses are highly cash-generative, with good visibility and stability, supported by the regulated transmission system operator business and long-term contracts. Leverage is driven by the group's financial strategy, which envisages a prudent initial equity funding of large investments and when operational, subsequent re-leveraging through upstreaming large dividends, always consistent with the strong commitment to preserve the current rating.

A total of EUR540 million equity injections by 2021 have been agreed for C4G investment with the shareholders and a further EUR200 million of capex until 2039 will be financed through its own cash flows. CPI investment will be 70% funded by equity and 30% by debt. In light of this dynamic and an expected CZK27 billion (around EUR1 billion) of dividends during 2019-2023, we forecast a progressively increasing net debt of almost CZK5.0 billion and related funds from operations (FFO) adjusted net leverage increase from 4.3x in 2018 to 5.4x in 2023; close but always within our negative guideline (5.5x).

Counterparty Concentration a Risk: N4G's increased counterparty exposure to Gazprom is mitigated by the historical performance of the parties under the contracts, the stronger Standalone Credit Profile of the counterparty (a-) and the continued importance of N4G's transit route in reaching shippers' ultimate customers. After the full commissioning of C4G, we expect Gazprom to contribute around 80% of N4G's revenue, with the rest represented by other large European utilities. All counterparties (including domestic) must meet the regulatory standard of the network code and payments are typically made in advance. The domestic regulation allows recovery of revenue deficits.

Regulatory Stability for Upcoming RP5: The regulatory framework in the Czech Republic allows recovery of operating costs (updated for inflation and an efficiency factor) and capex (through an allowed return on the regulatory asset base (RAB) and allowed depreciation). Fitch evaluates the Czech Republic gas transportation regulation as relatively transparent and stable and therefore supportive of N4G's rating. The regulator, Energy Regulatory Office, was established in 2001 and has a track record of consistent procedures and application of the RAB-based methodology.

The fifth regulatory period for gas transportation in Czech Republic will start in 2021, covering 2021-2025. The current consultation document envisages broad continuity with the current methodology providing visibility in the medium term. Smooth proposed changes are related to the introduction of profit sharing mechanism of extra efficiencies with end users, the reset of the allowed opex (based on the 2017-19 level), as well as a decrease in the allowed real rate of return to a 6.0% to 6.4% range (7.9% in the current regulatory period). The latter reflects the lower cost of capital, in line with other EU jurisdictions.

Gradual Convergence from RAB to NAV: The discrepancy among the RAB and net asset value (NAV), not present in western European frameworks, is an historical common issue for regulated utility companies in eastern European countries, where part of the networks were put in place under a completely different economic environment (1980s and 1990s), driving low RAB values. However, this mismatch has been recognised by the regulator since beginning of the third regulatory period and will be gradually corrected with a dual depreciation regime that will bring convergence in the long term. The RAB is currently around 30% lower than the NAV (FY18: CZK7.5 billion vs CZK10.8billion).

Limited FX Exposure: Fitch expects an increasing share of transit revenues in Czech koruna, which is also the currency for the domestic business, given new koruna-denominated contracts. New loans are also drawn in koruna in anticipation of a decreasing share of revenues in US dollars after 2021, linked to expiring transit contracts. In total, domestic transport and transit businesses generate more than half of N4G's revenues in koruna, followed by US dollars and euros. Costs are largely in koruna. N4G targets a cash flow hedge of FX using debt issued across the currencies and cross-currency swaps.

Derivation Summary

eustream, a.s. (A-/Stable) is Net4Gas's closest rated peer since both companies own and operate the gas transit pipelines in Slovakia and Czech Republic, respectively, although Net4Gas also benefits from a higher share of domestic business and, in our view, more supportive regulation. Both companies are highly dependent on the Russian gas transit to Europe with concentrated counterparty risk. However, eustream operates at significantly lower FFO net leverage of around 2.7x in our forecasts. N4G is in a weaker competitive position than its peers, Snam (BBB+/Stable) and Ren-Redes Energeticas Nacionals, SGPS, S.A (BBB/Stable), since Fitch considers earning from traditionally regulated networks to allow for higher debt capacity than long-term ship-or-pay contracts.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- C4G investment (NSII-related) to be at its full capacity of 40 bcm/a by early 2021.

- No short-term/uncontracted bookings

- Capex around CZK28 billion for 2019-2023, around 70% of which is equity funded

- Significantly higher dividends, up to CZK 6billion of which will be debt funded during the rating horizon (2019-2023)

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Expected FFO adjusted net leverage below 4.7x on a sustained basis (2018: 4.3x) and FFO interest coverage above 3.5x (2018: 9.0x), supported by shareholders' commitment to a higher rating and earnings from long-term ship-or-pay transit contracts with diversified counterparties and from domestic business

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Projected FFO adjusted net leverage above 5.5x and FFO interest coverage below 2.5x 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 key counterparty

- Deterioration in the domestic regulatory environment for gas transportation

Liquidity and Debt Structure

N4G's liquidity is supported by cash generative nature of business and strong pre-dividend FCF, as well as the currently undrawn EUR100 million (around CZK2.5 billion) committed revolving and overdraft facilities, which can be utilised in euros or koruna.

The company's cash and cash equivalents of CZK4.1 billion and the facilities of CZK2.5 billion will be more than sufficient for its debt maturities of CZK 0.5 billion, but they will not be sufficient for its capex needs of CZK7.5 billion, most of which is related to C4G investment. However, all C4G investment will be equity funded and the shareholders funded CZK4.6 billion during 9M19 and a further CZK3.1 billion is expected from them in 4Q19.

The shareholders are prudent in their dividend policy with a clear intention of maintaining the current rating.

ESG Considerations

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For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
NET4GAS, s.r.o.	LT IDR BBB ⭘ Affirmed		BBB ⭘
senior unsecured	LT BBB Affirmed		BBB

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Applicable Criteria

Sector Navigators (pub. 23 Mar 2018)

Corporate Rating Criteria (pub. 19 Feb 2019)

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