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Research Update:

Czech Republic-Based NET4GAS 'BBB' Rating Affirmed; Outlook Stable

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Overview

- NET4GAS continues to benefit from stable cash flow generation from long-term ship-or-pay contracts in the transit business, and from its regulated gas transmission operations in the Czech Republic.
- However, in the next two-to-three years, NET4GAS' customer concentration with Gazprom is likely to further increase when the Nord Stream 2 and Capacity4Gas pipelines are completed. Should the customer concentration increase further on a sustainable basis, this would increase business risk, in our view.
- That said, NET4GAS' solid liquidity and a prudent and flexible financial policy could mitigate this additional risk if it were to materialize.
- As a result, we are affirming our long-term 'BBB' rating on NET4GAS.
- The outlook remains stable.

Rating Action

On June 15, 2018, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on Czech gas transmission and transit grid operator NET4GAS s.r.o. The outlook is stable. We also affirmed the 'BBB' rating on NET4GAS' senior unsecured debt.

Rationale

The affirmation reflects our view of NET4GAS' strong business risk profile, 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. It also reflects the company's support from its regulated gas transmission operations in the Czech Republic, which offer low volatility of earnings and above-average profitability (85% EBITDA margin and 9.7% return on capital in 2017. We forecast these figures will be above 80% and 9%-10%, respectively, in our base case for 2018-2020). We expect that NET4GAS will maintain funds from operations (FFO) to debt of 18.0%-18.5% in 2018-2019 (it was 18.4% in 2017). The affirmation also reflects our view of NET4GAS' solid liquidity and a prudent and flexible financial policy, which are paramount factors to rating sustainability. At year-end 2017, NET4GAS posted an EBITDA of Czech koruna (CZK) 6.3 billion (down 20% from 2016 due to the expected expiration of one contract) and had debt of CZK27.1 billion.

NET4GAS operates more than 3,800 kilometers of pipelines in the Czech Republic.

We believe that NET4GAS forms a key part of the gas transit path to supply consumers in Western, Southern, and Eastern Europe, and will retain its key role in the future. This is thanks to its reversible routes (east-to-west or west-to-east), favorable location, and investments in the C4G project, which would increase NET4GAS' capacity to deliver Russian gas from Nord Stream 2 (NS2) further from Germany (where NS2 ends) to European customers. We recognize the multi-decade track record of long-term contracts with Gazprom, as well as Gazprom's and the Russian government's strong economic interest in continuing profitable gas exports to Europe, which requires timely payments for transit. We also take into account Gazprom's strategy, which is currently aimed at changing its export transit routes to Europe from Ukraine to new subsea pipelines, including NS2. In our view, this will enable NET4GAS to retain a strategic role in the delivery of Russian gas to European customers.

That said, we think NET4GAS' customer concentration to Gazprom (local currency: BBB/Stable/A-2, foreign currency: BBB-/Stable/A-3), which was 63% in 2017, constrains these credit strengths. This is because it represents both exposure to a single customer with lower credit quality than NET4GAS and exposure to Russia, where we assess country risk as high. We understand that, from 2020, NET4GAS' customer concentration with Gazprom may increase further and exceed 75% of cash flows, with the completion of the NS2 and Capacity4Gas (C4G) pipelines. If customer concentration with Gazprom reached such levels on a sustainable basis, we believe that it would be difficult for NET4GAS to replace Gazprom as a major shipper in the medium term, given the lack of alternative gas suppliers of comparable size in the region. This would also mean higher exposure to Russia and could result in a weakening of our assessment of NET4GAS' business risk and potentially a higher assessment of its cash flow volatility.

We consider NET4GAS' shareholders, Allianz Group and OMERS, to be strategic owners with a long-term investment horizon. We consider the owners to be supportive, and that dividends could be adjusted, if necessary, to ensure that NET4GAS maintains credit ratios consistent with the current rating. We expect that shareholders will continue to contribute equity over the next few years to support C4G capital expenditure (capex) requirements, according to the shareholders' agreement. We expect NET4GAS will complete the project in stages in 2019-2021, with the first cash flows for additional transit capacities starting in 2019.

In our base case, we assume:
- Transit revenues based on existing long-term contracts; uncontracted short-term bookings of CZK500 million in 2018-2019;
- Domestic transmission revenues based on the existing regulatory period prolonged for two years to end-2020;
- Capex of CZK2 billion in 2018 and about CZK4.2 billion in 2019;

- No additional debt, since equity will fund C4G, according to the shareholders' agreement;
- NET4GAS to construct the C4G project on time and on budget, with scheduled commissioning in stages in 2019-2021. The Czech-Poland Interconnector is still in the preparation stage in 2018, and we expect large-scale capex will start in 2020-2021. However, the final investment decision depends on the Polish transmission and system operator that is building the connecting pipeline, and the ultimate terms of the compensation arrangement, which have not yet been finalized;
- Equity contribution of CZK1 billion in 2018 and CZK3.7 billion in 2019; and
- Reasonable shareholders' approach to dividend payments.

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

- FFO to debt of 18.0%-18.5% in 2018-2019; and
- Debt to EBITDA of about 4x.

Liquidity

We assess NET4GAS' liquidity position as strong because we expect its ratio of sources to uses of funds will be about 3x over 2018 and at least 1x over 2019. 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, 2018, comprised:

- Unrestricted cash of about CZK2.4 billion;
- FFO that we estimate at about CZK4.2 billion-CZK4.3 billion in 2017;
- An undrawn committed revolving credit facility of €100 million, expiring in May 2022; and
- Equity injections of about CZK1.6 billion.

We anticipate that cash outflows for 2018 will include:

- Capex of about CZK2.5 billion-CZK2.6 billion;
- Dividends of about CZK700 million-CZK800 million, still subject to approval; and
- No maturing debt until 2021.

Outlook

The stable outlook reflects our 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. We also expect it to see a supportive regulatory environment, predictable cash flows from domestic transportation, a substantial liquidity cushion, and shareholders' commitment to maintaining the rating. Our base case assumes FFO to debt of 18.0%-18.5% in 2018-2019.

Downside scenario

We would consider a downgrade or revise our ratio targets for the rating if the company's credit quality deteriorated substantially. This could happen 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, unexpected operational issues, or higher operating expenses or capex than we currently anticipate.
- If we saw a deterioration of the credit quality of Gazprom, we would likely reconsider our view of NET4GAS's business risk profile.
- The company's exposure to the major shipper and related country risk increased sustainably above 75%, unless offset by stronger financial metrics.
- Adjusted FFO-to-debt ratio fell below 18%, for example, as a result of higher dividend payouts, operating expenses, or capex than we currently anticipate. If the exposure to the major shipper increased sustainably above 75%, the threshold would likely increase, to compensate for higher business risks.

We believe the shareholders are supportive and committed to maintaining 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, would, in our view, point to a shift in the shareholders' approach.

Upside scenario

We see the upside as limited in the next one-to-two years due to significant capex and the likely increase of customer concentration risk.

Ratings Score Snapshot

Issuer 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)

Issue Ratings--Subordination Risk Analysis

Capital structure

NET4GAS issues all debt at the parent company level. There is no financial debt at the operating subsidiaries.

Analytical conclusions

The issue rating on NET4GAS's senior unsecured debt is 'BBB', in line with the issuer credit rating, since no elements of subordination risk are present in the capital structure.

Related Criteria

- General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Industrials: Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General: Corporate Methodology, Nov. 19, 2013
- Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

NET4GAS s.r.o.	
Issuer 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.capitaliq.com. All ratings affected by this rating action can be found on 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.