FitchRatings

Fitch Affirms NET4GAS at 'BBB'; Outlook Stable

Fitch Ratings - Milan - 17 July 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' rating reflects N4G's consistent performance, a solid domestic regulatory regime and track record of supportive shareholders. Notwithstanding the acceleration on Capacity4Gas investments (C4G), the rating also continues not to fully reflect the future commissioning of Nord Stream II (NSII) as some uncertainties remain on the deliverability of the project by end-2019 at given capacity.

We currently view the commissioning of C4G as providing significantly higher and more predictable operating cash flow for N4G, but as rating-neutral as we believe the cash flow benefits would be offset by higher dividend outflow and increased counterparty concentration. We will re-evaluate the impact on rating and debt capacity of N4G, when we will have better visibility later this year.

Key Rating Drivers

Increasingly Important Transit Route: The strong business profile of N4G reflects its monopolistic status as the national transmission system operator in the Czech Republic, and its strategic role as a Russian gas transit corridor to Europe. When NSII is fully commissioned, it would emphasise the international gas transit role of the Czech Republic network (total transported volume of 48 billion cubic meters (bcm) in 2018, 8bcm of which was for domestic consumption), also in light of the expected trend of increasing European gas consumption and growing reliance on Russian gas.

Acceleration of C4G Investment: Capacity4Gas capex-phasing has been accelerated, with an expected investment of more than EUR370 million by end-2019 or almost 70% of the entire project (up from 30% previously expected). This has been followed by corresponding equity injections broadly matching the project's cash outlays, demonstrating shareholder support and commitment to preserving credit metrics.

NSII Neutral for Ratings: Although the commissioning of C4G would lead to significant improvements in N4G's cash flow visibility (1.122GWh/day transmission capacity contractually secured until 2039) and the associated returns, Fitch expects the benefits to be largely offset by dividend maximisation to levels consistent with the current rating and moderately increased counterparty risk. Our current rating case does not assume any cash flows related to C4G due to the project's execution risk, and our forecasts are based on more conservative, less predictable revenues that would progressively decline. Funds from operations (FFO) adjusted net leverage is expected to increase during 2019-2022, but we expect it to be commensurate with a 'BBB' rating, supported by a flexible shareholder distribution policy.

Counterparty Risk: N4G's counterparty exposure to Gazprom PJSC (BBB-/Positive) will increase when C4G is commissioned. This does not constrain the ratings due to the historical performance of the parties under the contracts, the stronger standalone credit profile of the counterparty, and the continued importance of N4G's transit route in reaching shippers' ultimate customers. Other counterparties include large European utilities. All counterparties (transit or domestic) have to meet the regulatory criteria of the network code, and payments are typically made on advance invoices. The regulatory framework allows recovery of revenue deficits in the domestic business.

Limited FX Exposure: Fitch expects an increasing share of transit revenues in Czech koruna (CZK), which is also the currency for the domestic business, given new CZK-denominated contracts. New loans are also drawn in CZK 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 CZK, followed by US dollars and euros. Costs are largely in CZK. 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 N4G's closest rated peer since both companies own and operate the gas transit pipelines in Slovakia and Czech Republic respectively, even though N4G also benefits from domestic gas 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 S.p.A. (BBB+/Stable) and REN-Redes Energeticas Nacionals, SGPS, S.A. (BBB/Stable), since Fitch views earnings from traditionally regulated networks as more visible than long-term ship-or-pay transit contracts.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

-Expiring contracts to be partially replaced by short-term bookings

-Capex around CZK12 billion for 2019-2023, more than half of which are equity funded

-Czech-Polish Interconnector (CPI) capex to be 70% equity-funded

-Regulatory returns in line with the determination for RP4 (2016-2020) regulatory period

-Flexible dividend policy (CZK1 billion a year assumed in 2019-2022)

RATING SENSITIVITIES

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

-Expected FFO adjusted net leverage sustainably below 4.7x (2018: 4.3x) and FFO interest coverage above 3.5x (2018: 9.0x), supported by shareholders' commitment 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 5.2x 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 of and increase in exposure to key counterparty

-Deterioration in the domestic regulatory environment for gas transmission

Liquidity and Debt Structure

Strong Liquidity: Cash and cash equivalent of CZK4.1 billion, along with an undrawn revolving facility agreement of CZK2.1billion as of end-2018, are more than sufficient to cover short-term maturities of CZK522million. N4Gs's liquidity is further supported by strong pre-dividend free cash flow, due to the cash-generative nature of the company's business. Shareholders are supportive in their dividend policy by allowing flexible payments such that N4G can maintain a strong balance sheet that is commensurate with an investment-grade rating.

Sources of Information

RATING ACTIONS

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

Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

DISCLAIMER

COPYRIGHT

SOLICITATION STATUS

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

Endorsement Policy

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Fitch Updates Terms of Use & Privacy Policy

We have updated our Terms of Use and Privacy Policies which cover all of Fitch Group's websites. Learn more.