FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms NET4GAS at 'BBB'; Outlook Stable

Fri 13 Nov, 2020 - 7:27 AM ET

Fitch Ratings - Milan - 13 Nov 2020: 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 solid operating cash flow stability and high long-term visibility, attributable to the Gazelle and Capacity4Gas (C4G) ship-or-pay contracts with Gazprom (BBB/Stable) as well as a supportive domestic regulatory framework, whose fifth period (RP5) parameters are approved until 2025.

N4G shareholders have a prudent approach to leverage, executing and committing large equity injections in parallel to investments in the C4G and expected Moravian capacity extension (MCE) projects. For 2021-2022, N4G plans to re-leverage its capital structure towards its target leverage that is consistent with its rating sensitivity (5.5x funds from operations (FFO) net leverage).

KEY RATING DRIVERS

Limited Exposure to Pandemic: N4G has continued to operate its assets during the pandemic, without reporting any major problem or significant extraordinary costs. We expect drops in gas demand and in related spot prices to have a negligible financial impact on N4G given the nature of ship-or-pay transit contracts (only around up to CZK320million p.a. Gazelle ship-or-pay revenues are fully volume-related) and a well-defined regulatory true-up mechanism on the transportation business. Delays to investment - and especially on the main milestones for C4G - was the main risk associated to the pandemic, but the January 2021 final stage commissioning is expected to be achievable, also confirmed by management.

2020 Record Year: Fitch expects 2020 to be an exceptionally positive year for N4G, with a 25% yearly increase in EBITDA to CZK8.7 billion and related deleveraging to 3.8x FFO net leverage, also supported by a CZK4.4 billion C4G-related equity injection from its shareholders. The profit gain has been mainly attributable to revenues from the C4G ship-or-pay contract and lower-than-expected fuel energy costs.

Supportive Fifth Regulatory Review: Czech Republic's transparent and stable gas transportation regulation supports N4G's current long revenue visibility. The RP5 will cover 2021-2025, in broad continuity with the past, incorporating a decrease to 6.4% in the allowed real rate of return. A 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 revenues" to progressively increase to more than CZK2,200 million in 2025 (up around 20% vs. 2020), taking also into consideration the 95% RAB inclusion of the Moravian pipeline project.

Czech-Polish Interconnector Outside Rating Horizon: N4G's Czech-Polish interconnector investment has been excluded from our rating case due to the lack of visibility of the remuneration mechanism. This would exclude around CZK5.5 billion of capex in 2021-2025 (70% expected to be equity-funded) and a related CZK550 million annual revenue contribution when operational. Aside from maintenance and ordinary replacement, current 2020-2025 investment plan includes the completion of C4G (CZK6.2 billion -100% equity-funded) and the MCE investments for enhancing supply security on the Moravian territory (CZK4.5 billion; 70% equity- funded), including an 85km pipeline extension.

Predictable and Cash-Generative: N4G's transport and transit businesses are highly cash-generative, leading to an historical and projected EBITDA margin above 85%. In 2021-2025, EBITDA and FFO are expected to remain stable at an average of CZK7.3 billion and CZK5.5 billion, respectively, underpinned by a solid RP5 framework and stable contracted capacity above 60bcm/year. Investment would progressively decrease from more than CZK5.5 billion in 2021 - mostly related to the MCE and C4G projects - to around its maintenance level of CZK800 million-CZK700 million in 2022-2024, freeing up large pre-dividend free cash flows (FCF).

Expected Re-leveraging up to Sensitivity: Given its high and stable cash flow from operations, the capital structure is mostly determined by N4G shareholders' financial strategy. N4G aims for prudent initial equity-funding of large investments, which once operational, will allow the group to re-leverage to upstream large dividends. This is what we expect for 2021 and 2022, when C4G and MCE would be fully commissioned and gross and net debt will increase by around CZK5 billion (due largely to dividends), raising FFO net leverage to 5.4x in 2022 from 4.3x in 2019 but within our negative sensitivity of 5.5x.

Counterparty Concentration Risk: N4G's increased 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 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 around 75% of N4G's revenue and other large European utilities for the rest of 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.

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 and Nord Stream II (NSII), in the respective north-south (until 2035) or west-east directions (2039). Contractual ship-or-pay C4G is not dependent on NSII being commissioned and therefore not subject to geopolitical tensions between the US and Russia. However, NSII incompletion for long term would exacerbate the mismatch between available capacity and actual gas flow, increasing the risk of forced renegotiation.

Well-Balanced FX Exposure: Fitch expects an increasing share of transit revenues in Czech koruna, which is also the currency for the domestic business, as koruna-denominated C4G contracts ramp up. 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 almost 80% of N4G's revenues in koruna, followed by US dollars. Costs are largely in koruna. N4G hedges potential FX-related cash flow fluctuations using debt issue in US dollars and cross-currency swaps to maintaining leverage neutrality to FX movements.

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, although N4G also benefits from a higher share of domestic business and, in our view, more supportive regulation 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 significantly lower FFO net leverage of around 2.7x in our forecasts.

N4G is in a weaker competitive position than fully regulated national TSO peers such Snam S.p.A. (BBB+/Stable) and Ren-Redes Energeticas Nacionals SGPS S.A (BBB/Negative), or than the 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 NG4, 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 debt to be notched up from the IDR, unlike for that of Czech Gas Network Investment, given its dominant contribution of high-quality regulated activities.

KEY ASSUMPTIONS

-Revenue based on the current regulatory framework until December 2020. Broad regulatory continuity from January 2021, in line with the current published framework (weighted average cost of capital at 6.43%) and RAB reconciliation with NAV within RP5, including also the Moravian capacity expansion investment (2022);

-C4G investment (NSII-related) to be at its full annual capacity by 2021 and no short-term/uncontracted bookings from 2020 onwards;

-Expected annual EBITDA averages about CZK7.3 billion in 2021-2025;

-Cost of new debt and tax rate in line with historical levels;

-Decreasing annual capex from more than CZK7 billion in 2020 to less than CZK1 billion from 2023 onwards; and

-Significant annual dividends averaging at around CZK5.4 billion until 2025.

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 (2019: 4.3x) and FFO interest coverage above 3.5x (2019: 8.3x), supported by shareholders' commitment to a higher rating; moreover, higher earnings from long-term ship-or-pay contracts with diversified counterparties and from the domestic business

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

- Projected FFO 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

- Delay to Moravian capacity extension project without adequate mitigation by 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

N4G's satisfactory liquidity is supported by the cash-generative nature of the gas transport business leading to strong pre-dividend FCF and prudent equity-funding of large investments (i.e. C4G, MCE). Its conservative financial planning is reflected in its currently undrawn committed term loan facilities of CZK10.3 billion obtained in 1Q20 and historical EUR100 million (around CZK2.6 billion) committed undrawn revolving and overdraft facilities, which can be utilised in euros or koruna.

Its estimated cash and cash equivalents of CZK0.6 billion at end-2020, undrawn facilities (around CZK12.9 billion in total) and expected positive pre-dividend FCF of CZK0.7 billion will be more than sufficient to cover its 2021 large bond debt maturities of CZK12.9 billion. On the other hand, dividend distribution higher than equity injections are expected to be financed by new debt.

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
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

Antonio Totaro
Senior Director
Committee Chairperson
+39 02 879087 297

MEDIA CONTACTS

Adrian Simpson
London
+44 20 3530 1010
adrian.simpson@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Country-Specific Treatment of Recovery Ratings Rating Criteria (pub. 27 Feb 2020)

Corporate Rating Criteria (pub. 01 May 2020) (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

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