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Research Update:

CEZ a.s. Outlook Revised To Negative On Tight Financial Headroom Amid Market Turmoil; Ratings Affirmed

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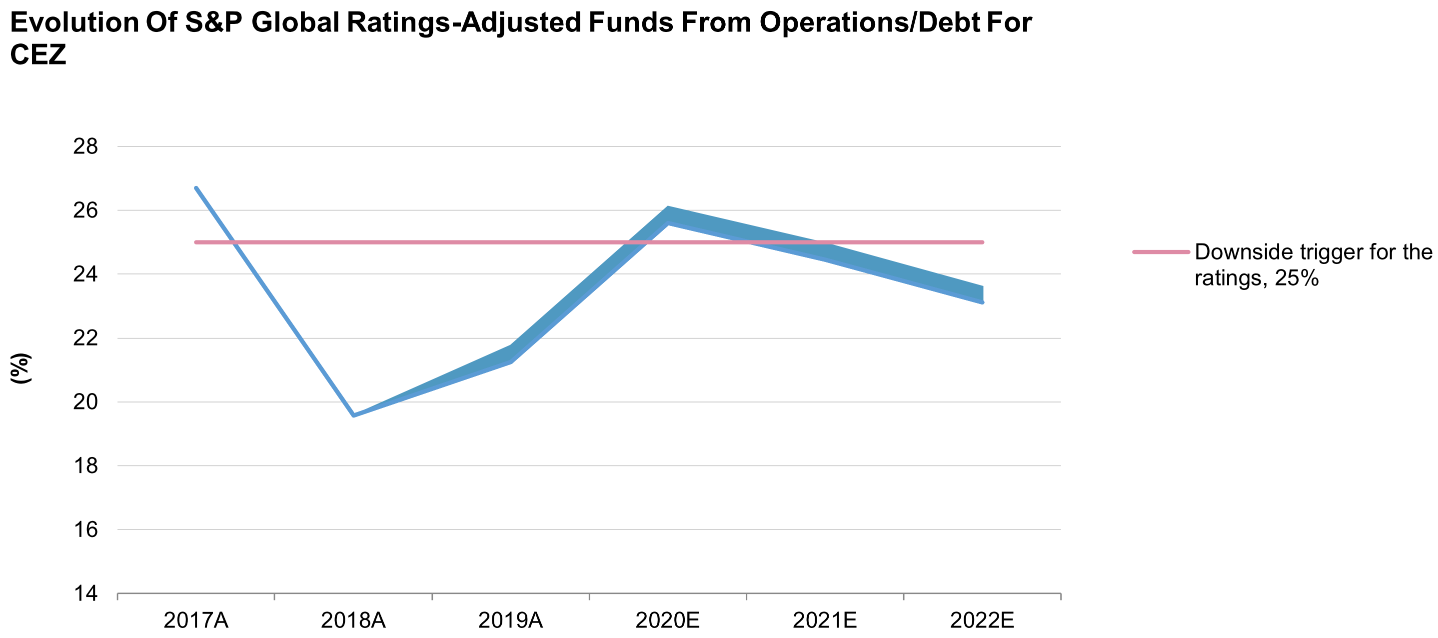
Rating Action Overview

- Given a likely European economic slowdown in the context of the COVID-19 pandemic, we believe that CEZ's earnings could be pressured by lower power prices on unhedged positions growing from 2021. In addition, we cannot exclude a lower volume of electricity generation in 2020 following the lockdown that began on March 16, 2020, due to COVID-19.
- Our current forecast for CEZ's financial improvement over 2020-2022 supports the current rating, but headroom under the rating is limited.
- We are affirming the 'A-' long-term issuer credit rating.
- The negative outlook reflects our view of CEZ's limited headroom under our forecasts to maintain funds from operations to debt above the 25% needed to maintain the current rating.

Rating Action Rationale

CEZ had limited rating headroom before the start of the COVID-19 outbreak. CEZ's financial metrics have been below our threshold since 2018. In 2018, the delayed fallout from historically low power prices (approximately €31 per megawatt hour [MWh]) led to funds from operations (FFO) to debt of 20%. CEZ's fiscal year 2019 results were positive, with reported EBTIDA growing by 21% on a yearly basis thanks to more favorable power prices on generation hedged (approximately €36/MWh), but FFO to debt was still below 25% at 21%. This was primarily because of unexpected working capital cash outflows, most of it due to carbon dioxide (CO_2) allowances purchased on spot and currently held for consumption in the following years. This is also due to the update of asset retirement obligations following the recent cost study of Temelin Nuclear Power Plant and a reduction on its discount rate. Before the start of the COVID-19 outbreak, we were expecting financial improvement over 2020 to 2022 thanks to higher power prices on generation hedged (approximately €44/MWh), but we now believed that this could be threatened by current market conditions. In addition, the current lockdown in the Czech Republic could affect electricity demand in 2020.

Chart 1



Note: As adjusted by S&P Global Ratings. A--Actual. E--Estimate. Source: S&P Global Ratings.

CEZ remains protected from lower wholesale prices in 2020 since 86% of its production is hedged, but the hedge ratio decreases as of today and will affect the average hedged price. CEZ's generation fleet is predominantly fixed-cost and contributes substantially to the group EBITDA, which exposes consolidated EBITDA to market conditions. The company compensates for this exposure through gradual hedges on generation over the next two to three years. Over the past six months (and more so since the beginning of the COVID-19 outbreak and drop in oil prices), however, wholesale prices in Europe have dropped substantially due to a combination of low commodity prices (gas, carbon, and coal) and a mild winter. A positive is that in 2020, 86% of CEZ's generation is already hedged at €43.6/MWh. The hedge ratio coverage declines over time, which could affect credit metrics. Of its generation, 57% is hedged at €45.7/MWh in 2021 and 26% in 2022 (€47.7/MWh). The impact of lower wholesale prices could be partially mitigated on the coal generation fleet, which accounts for 39% of total generation, since it will benefit from lower CO2 allowances which reduces its cost base.

An ambitious capex plan will pressure metrics, while divestments could be delayed. CEZ began a gradual sale process of most of its assets in Bulgaria, Romania, Turkey, and Poland after revising its strategy in June 2019. Although we believe that there should be demand for these assets, current market conditions could have an impact, especially in terms of timing. The divestments aim to partly finance CEZ's strong investment program that is mainly focused on the energy transition in the Czech Republic. The current capital expenditure (capex) budget from 2020 to 2022 is approximately Czech koruna (CZK) 110 billion-CZK120 billion (€4.2 billion-€4.6 billion).

These investments will support CEZ's business risk profile over the long term, but would pressure credit metrics over the medium term if the divestment plan is delayed. A separate potential long-term driver is that the Czech government and CEZ are analyzing the feasibility of a new nuclear power plant to replace Dukovany starting in 2036. Under the current preferred solution, CEZ would develop a new nuclear reactor against a contract between CEZ and the government--details of the contract and how it could affect CEZ are still not clear yet but it could be material and we are monitoring any progress in the discussion. (See "CEZ a.s.," published Sept. 27, 2019, for further information)

The company has material refinancing needs over the next three years. CEZ will need to refinance approximately 45% of its current financing from 2020-2022. The company has already secured its refinancing needs for 2020, leading us to assess its liquidity for the next 12 months as adequate. In addition, CEZ benefits form a solid relationship with its banks and a high standing in the credit markets.

Outlook

The negative outlook reflects our view of the current pressures on CEZ's forecast metrics. The company's performance remains solid, with a strong position in the Czech Republic, and pressure on the cash flows steaming primarily from its investment plan amid turbulent market conditions. We do expect a negative impact on our previous forecast from 2021 onwards due to lower wholesale electricity prices, which have declined by approximately €10/MWh between November 2019 and March 2020. The impact on 2020 metrics should be limited since 86% of production is hedged, although we cannot exclude lower production following the lockdown that began on March 16 due to COVID-19. In addition, the company faces significant refinancing needs over the next three years, representing approximately 45% of its current financing.

Our view of the rating could be constrained upon further signs of increased political risk--for example, policies that aim to extract cash from power utilities in the Czech Republic, either through increased dividends or windfall taxes--that have adverse implications for CEZ's financial metrics and leading, for example, to a negative discretionary cash flow-to-debt ratio. This would also stem from the Czech government's decision to use CEZ to fund the new nuclear project, for example if CEZ finances the plant's construction against its own balance sheet, leading to significant deterioration of credit metrics combined with construction risk.

We could also downgrade CEZ if we lowered the local currency rating on the Czech Republic. Increased political uncertainty and evidence of detrimental government intervention could also undermine our current assessment of the likelihood of extraordinary support to CEZ from the Czech government, which could prompt us to downgrade CEZ.

Upside scenario

We could revise the outlook to stable if we expect stronger the credit metrics for CEZ, with FFO to debt comfortably above 25% both in fiscal year 2020 and under our forecast.

Absent a potential favorable outcome regarding the government's reorganization of the company--not incorporated in our base case at this stage--we currently see the upside potential for the rating as limited. This would require either a substantial, two-notch upward revision of CEZ's stand-alone credit profile, a higher assessment of the likelihood of extraordinary government support, or an upgrade of the Czech Republic.

Company Description

CEZ is an integrated energy company with a wide range of electricity-related businesses: generation, distribution, supply, mining, and energy trading. The utility benefits from an unrivaled position in the Czech electricity market and a small presence in Central and Eastern European countries, mainly Romania, Bulgaria, and Poland. CEZ has a market share of about 70% of the generation segment in the Czech Republic, with a total capacity in 2019 of 14.6 gigawatts (GW) (out of which 13.3 GW is located in the Czech Republic) and a total production of 64.6 terawatt hours (TWh) (of which 60.6 TWh was generated in the Czech Republic). The generation mix comprises mostly nuclear and lignite/hard coal (86%). The latter is supported by its ownership of the Czech Republic's largest mining company, which provides 72% of CEZ's lignite needs. CEZ sold externally about 28% of the coal extracted. Coal-fired power plants represented 45% of capacity and 39% of generation volume in 2019, and their revenues are less than 20% of the group's total. The utility also has an overall market share of 27% in the competitive Czech supply market and supplied 16.7 TWh of electricity to its end customers in 2018.

CEZ controls about 65% of the Czech Republic's electricity distribution, owning the largest distribution company in the country. Regulated operations contributed about 40% and 34% of EBITDA in 2018 and 2019, respectively. The Czech Republic is CEZ's largest shareholder, with a stake of nearly 70% in the company's share capital and voting rights. The remaining 30% is publicly listed.

Our Base-Case Scenario

Our base-case scenario is under constant revision as we continue to assess the impact of current economic conditions:

- Real GDP growth in Czech Republic of 3.0% in 2018, 2.5% in 2019, and 2.3% in 2020.
- Limited impact in 2020 on electricity consumption in the Czech Republic due to COVID-19, followed by a moderate recovery in 2021.
- Share of production hedged: 86% in 2020 (€43.6/MWh), 57% in 2021 (€45.7/MWh) and 26% in 2022 (€47.7/MWh).
- No significant changes to the regulatory framework for distribution companies, although the current Czech regulatory period ends in 2020.
- EBITDA margins around 30%.
- Annual investments averaging about CZK36 billion-CZK40 billion over 2020-2022.
- Dividend payout ratio averaging 90%.
- Collection on the receivables of the sale of the Romanian assets in 2021.
- No large, debt-financed acquisitions.

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

- Adjusted FFO of about CZK57 billion in 2020 and CZK47 billion in 2021.
- Adjusted debt increasing to CZK219 billion in 2020 and afterwards declining to CZK191 billion 2021 and increasing toward €48 billion from 2022.
- FFO to debt above 26% in 2020 declining to 25.0%-24.0% in 2021-2022 (see chart 1).

- Debt to EBITDA of 3.2x in 2020, increasing toward 3.3x-3.5x on 2021-2022.

Liquidity

We view CEZ's liquidity position as adequate under our criteria, based on our expectation that available liquidity resources will cover expected cash outflows by more than 1.2x in the next 12 months.

We expect principal liquidity sources over the 12 months from Dec. 31, 2019, will include:

- Unrestricted cash and securities of CZK12.4 billion, according to management data;
- Available headroom of about CZK33.3 billion under various committed back-up facilities maturing after 12 months;
- Cash FFO of about CZK49.6 billion; and
- Working capital inflows of about CZK4.9 billion.

We expect principal liquidity uses over the same period will include:

- Debt maturities of about CZK29.7 billion;
- Annual capex of about CZK37.0 billion for 2020, per the company's guidance; and
- Dividend reflecting a payout ratio of 80%-100%.

Environmental, Social, And Governance

Over the past decade, CEZ has committed to generate carbon-neutral electricity before 2050 and has implemented several measures to reduce its CO_2 emissions intensity (361 grams of CO_2/MWh in 2019 versus 570 tons of CO_2/MWh in 2010) by upgrading its lignite fleet and planning to close some of its least efficient lignite and hard coal plants. We believe CEZ remains significantly exposed to challenges from carbon price developments and EU decarbonization objectives in light of its carbon-intensive fleet (electricity generation from coal was approximately 41% of total output, or 26.4 TWh, in 2019). Additional risks lie in its sizable nuclear fleet (47% of output in 2019). In 2017, the group mismanaged the documentation of welded joints on piping in nuclear power plants, causing significant outages and additional costs. Its end-of-cycle liabilities (of both decommissioning and nuclear waste storage) are also substantial and captured in our asset retirement obligation debt adjustment (approximately CZK54 billion in 2019).

From a social perspective, the Czech Republic's main political parties support both nuclear and coal, acknowledging nuclear generation's central role in preserving national energy independence. There are limited renewable ambitions, stemming from the country's limited natural and weather potential for wind and solar generation. CEZ's nuclear activities also pose several governance risks, as we believe uncertainty surrounding the government's decision on future nuclear reactor construction will continue to limit the long-term visibility of the group's overall structure and strategic directions.

Ratings Score Snapshot

Issuer credit rating: A-/Negative/--

Business risk: Strong

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Significant

- Cash flow/leverage: Significant (Standard volatility table)

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related government rating: AA

- Likelihood of government support: Moderately high (+2 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | 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 Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, 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

Related Research

- CEZ a.s., Sept. 27, 2019

Ratings List

Ratings Affirmed; Outlook Action

	To	From
CEZ a.s.		
Issuer Credit Rating	A-/Negative/--	A-/Stable/--
Senior Unsecured	A-	A-