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Research Update:

Estonia-Based Eesti Energia AS Downgraded To 'BBB' On Weakened Cash Flows And Credit Metrics; Outlook Stable

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Research Update:

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Overview

- Lower power prices have added pressure to Estonian power company Eesti Energia's credit metrics, as weaker operating cash flows are not expected to be offset by a reduction in debt.
- We have therefore revised our assessment of Eesti Energia's stand-alone credit profile to 'bb+' from 'bbb-'; however, we continue to view Eesti Energia as a government-related entity with a moderately high likelihood of receiving timely and sufficient extraordinary support if needed.
- We have lowered our rating on Eesti Energia to 'BBB' from 'BBB+'.
- The stable outlook reflects our assumption that Eesti Energia's stand-alone credit profile and the moderately high likelihood of extraordinary government support will remain unchanged over the coming two years.

Rating Action

On June 29, 2015, Standard & Poor's Ratings Services downgraded Estonian power company Eesti Energia AS to 'BBB' from 'BBB+'. The outlook is stable.

Rationale

The downgrade follows worsening market conditions that have resulted in weakening operating cash flows for Eesti Energia. We do not anticipate that a debt reduction will offset this weakening, and we have consequently revised downward our forecasted credit metrics for the company. We have also reassessed our view of Eesti Energia's financial risk profile to "significant" from "intermediate."

Consequently, we have lowered Eesti Energia's stand-alone credit profile (SACP) to 'bb+' from 'bbb-,' but we continue to view the likelihood of extraordinary government support for the group as "moderately high."

We continue to view Eesti Energia's business risk profile at the lower end of our "satisfactory" category, and we view the group's financial risk profile at the weaker end of our "significant" category, which offsets the benefit from ongoing support from its owner, the Estonian government. We view Eesti Energia as a government-related entity (GRE) with a "moderately high" likelihood that the Republic of Estonia would provide timely and sufficient extraordinary support to the group in the event of financial distress. This leads us to apply two notches of uplift to the SACP.

In our opinion, Eesti Energia's business risk profile is at the weaker end of "satisfactory." The company is increasingly exposed to competitive and volatile wholesale power markets following Estonia's full liberalization and the gradual interconnection of Nordic and Baltic power markets, where prices have fallen gradually recently. As the group's power price hedges gradually are renewed at lower prices, this has hurt earnings and cash flows. In addition, Eesti Energia's very fossil-fuel-intensive generation portfolio exposes the group to potentially higher costs for carbon emissions. However, Eesti Energia benefits from a material amount of free carbon emission allowances related to the construction of a new power plant aimed at reducing the group's future carbon emissions.

The group's vertically integrated oil-shale operations reduce the risk of fuel shortages and fuel price volatility. The current strategy is to increase the value added from the group's oil-shale resources by increasing its shale oil production, though we believe the group's competitive position in this area to be constrained by its small-scale operations. The group has experienced delays in the startup of a new shale oil plant, which is forecast to reach full capacity in 2016.

Eesti Energia continues to benefit from its dominant position in Estonia's retail power market. Despite a falling domestic retail market share, Eesti Energia continues to hold a retail market share of about 25% in the Baltics and 60% of the domestic Estonian market. The business risk profile is also supported by the regulated distribution network activities, which contributed about 30% of EBITDA in 2014 providing stability to cash flows. The full-cost cover of the regulatory framework continues to provide predictability and support, though there is no set regulatory period, and the tariff is fixed until an application from the operator is submitted for review.

We base our reassessment of Eesti Energia's "significant" financial risk profile on our expectation that credit measures will weaken, with funds from operations (FFO) to debt and debt to EBITDA projected to about 22% and 3.5x, respectively, over the next few years. Eesti Energia's credit metrics have deteriorated over the past few years following significant investments aimed at modernizing the very fossil-fuel-intensive generation fleet, which has been exacerbated by worsening market conditions. We do not expect the pressure on power prices to be fully mitigated by a reduction in debt. Although large-scale investments are reaching completion and capital expenditures are forecast to decline over the coming years--to the point that the majority is to cover maintenance needs--we do not expect credit metrics to recover to previous levels. This is further reflected in the company's revised financial target for net debt to EBITDA to below 3.5x from 3.0x.

Under our base case, we assume:

- In 2015, lower EBITDA and FFO compared with 2014 due to lower sales price stemming from worsened market conditions and thereby weaker achieved

prices after hedges.
- EBITDA and FFO, to recover in 2016, as sales volumes are forecast to increase.
- Capital expenditures of about €300 million in 2015, declining considerably in 2016, as the group's investment program is close to completion.
- Dividends of €95 million in 2015.

Based on these assumptions, we arrive at the following credit measures for 2015 and 2016:
- FFO to debt of about 20%–22%.
- Debt to EBITDA of approximately 3.8x-3.6x.

In accordance with our criteria for rating GREs, we consider that there is a "moderately high" likelihood of timely and sufficient extraordinary support for Eesti Energia from the Estonian government if the group were to face financial distress. This is based on our assessment of Eesti Energia's:
- "Strong" link with the Estonian government, its sole owner. We believe the government's stake in Eesti Energia is unlikely to fall below 50%.
- "Important" role for the government. Eesti Energia's operations are strongly aligned with the government's interests, in particular in ensuring Estonia's self-sufficiency in electricity.

Liquidity

We consider Eesti Energia's liquidity to be "adequate," as our criteria define this term. This is based on our estimate of the group's cash resources (including FFO) covering cash outflows by more than 1.2x over the next 12 months. We also account for our view of Eesti Energia's sound relationships with banks and satisfactory standing in credit markets. We also expect sources to exceed uses even if EBITDA declined by 15%.

As of March 31, 2015, we calculate the following principal liquidity sources:
- About €200 million in cash and equivalents, most of which we believe is available. The group also had full availability under three committed bilateral revolving credit facilities that total €150 million and mature in September 2018.
- FFO of at least €235 million, by our estimates.

At the same date, we calculate the following principal liquidity uses:
- Minor debt maturities of about €7 million in 2015 and about €20 million in 2016.
- Capital expenditures of about €270 million over the next 12 months.
- Expected dividends of some €95 million in 2015.

We understand that the company has financial covenants in some of its loan agreements. We assume that the company will continue to adhere to these covenants, though we understand that headroom under the covenants is reducing in line with the weakening operating cash flows.

Outlook

The stable outlook reflects our assumption that Eesti Energia's SACP and our view of the "moderately high" likelihood of timely and sufficient extraordinary government support will remain unchanged over the coming two years. We base this assumption on our anticipation of a decrease in investments as large-scale projects near completion and increasing contributions from the new shale oil plant, as it is expected to reach full capacity in 2016. In our view, these factors will partly mitigate the negative impact from continued difficult market conditions on EBITDA and FFO over the next few years. We also expect ongoing support for Eesti Energia from the Estonian government, such as through additional equity contributions if needed, to fund any new expansionary investments. We believe that these factors should help Eesti Energia maintain credit measures in line with the current rating. We consider ratios of adjusted FFO to debt of above 20% and adjusted debt to EBITDA of about 3.5x to be consistent with the 'bb+' SACP, provided our assessments of Eesti Energia's business risk profile and ongoing government support remain unchanged.

Downside scenario

Under our criteria for GREs, we would lower our rating on Eesti Energia by one notch if we reassessed the SACP down to 'bb', assuming that the likelihood of extraordinary support and the long-term sovereign rating remained unchanged. The SACP could come under pressure if the business risk profile weakened, for example, following a material decline of power prices or failure of investment projects. These situations could also lead to weaker credit measures compared with our base-case expectations, with, for example, FFO to debt falling below 20%, which would not be consistent with current SACP and ratings. Deteriorating liquidity could also pressure the SACP. Moreover, we would consider a negative rating action if we revised downward our assessment of the likelihood of extraordinary government support because, for example, the government no longer held a majority stake in the group or we believed that Eesti Energia's importance for the government had diminished.

Upside scenario

We currently see limited upside rating potential because of the constraints on Eesti Energia's credit measures and our view that the business risk profile is unlikely to improve given the challenging market conditions. The SACP would need to improve to 'bbb-' for us to consider an upgrade under our criteria for GREs. This could occur if, for example, FFO to debt returned to about 30% on a sustainable basis. If we assessed that there was a higher likelihood of extraordinary government support, this could lead to an upgrade of Eesti Energia. However, we currently see this as unlikely.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/--

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bb+

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

Stand-alone credit profile: bb+
- Sovereign rating: AA-/Stable/A-1+
- Likelihood of government support: Moderately high (+2 notches from SACP)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology and Assumptions, March 25, 2015
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Oil And Gas Exploration And Production Industry , Dec. 12, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: May 2015, May 29 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Ratings List

Downgraded

	To	From
Eesti Energia AS		
Corporate Credit Rating	BBB/Stable/--	BBB+/Stable/--
Senior Unsecured	BBB	BBB+

Additional Contact:
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