Credit Research – Eesti Energia – May 2, 2012

Quarterly credit comment

Eesti Energia

Q1 12 Flat revenues supported by the sale of the telecommunications subsidiary

Revenues came in at EUR 236 m in Q1 2012, showing a decline of 0.5% YoY. EBIT grew 28.1% YoY to EUR 56m and operating profit amounted EUR 56m. The improvement in profitability was due to the sale of the telecommunications subsidiary (Televõrgu AS) to Tele 2. In addition, the results were positively affected by the increased sales margin of Distribution Network and an increase of shale oil sales revenue. The negative impact arose from a decrease in electricity and heat sales volumes and increased depreciation.

Operating cash flow decreased by 43.7% YoY to EUR 59m, which was mainly affected by adjustments regarding the sale of a telecommunications subsidiary (EUR -13.6m), increased trade receivables (EUR -7.1m) and increased inventories (EUR -5.8m). Q1 2012 CAPEX increased 35.0% to EUR 129m. Eesti Energia continues to implement its investment plan as total 2012 CAPEX is expected to reach EUR 560 m.

As of the end of Q1 2012, there were EUR 27.2m worth of liquid assets. At quarter end, Eesti Energia had used EUR 25m of EUR 595m credit facilities and subsequently has EUR 570m worth of undrawn credit facilities.

At the end of Q1 2012, Eesti Energia’s net debt stood at EUR 458m, making the net debt to EBITDA ratio 1.6. The net debt to EBITDA is expected to rise due to the company’s extensive CAPEX programme.

<table>
<thead>
<tr>
<th>EUR m</th>
<th>Q1 2012</th>
<th>Q1 2011</th>
<th>diff</th>
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<tbody>
<tr>
<td>Revenues</td>
<td>236</td>
<td>237</td>
<td>-0.5%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>82</td>
<td>67</td>
<td>23.7%</td>
</tr>
<tr>
<td>Operating profit</td>
<td>57</td>
<td>44</td>
<td>28.1%</td>
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<tr>
<td>Profit for the period</td>
<td>56</td>
<td>42</td>
<td>32.3%</td>
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<tr>
<td>Total assets</td>
<td>2,103</td>
<td>1,897</td>
<td>10.9%</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>12</td>
<td>75</td>
<td>-84.3%</td>
</tr>
<tr>
<td>Interest-bearing liabilities</td>
<td>481</td>
<td>358</td>
<td>28.6%</td>
</tr>
<tr>
<td>Equity</td>
<td>1,283</td>
<td>1,159</td>
<td>10.7%</td>
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<tr>
<td>Cash flow from operating activities</td>
<td>59</td>
<td>105</td>
<td>-43.8%</td>
</tr>
<tr>
<td>Net debt</td>
<td>459</td>
<td>95</td>
<td>381.9%</td>
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<tr>
<td>Net debt/EBITDA</td>
<td>1.63</td>
<td>0.42</td>
<td>288.1%</td>
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<tr>
<td>Net debt/Equity</td>
<td>0.36</td>
<td>0.08</td>
<td>335.4%</td>
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<tr>
<td>Operating margin</td>
<td>24.0%</td>
<td>16.6%</td>
<td>28.8%</td>
</tr>
<tr>
<td>EBITDA interest coverage</td>
<td>16.0</td>
<td>16.5</td>
<td>-3.0%</td>
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<td>FFO/Net debt</td>
<td>0.18</td>
<td>0.68</td>
<td>-73.8%</td>
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<tr>
<td>ROIC</td>
<td>13.4%</td>
<td>13.3%</td>
<td>0.8%</td>
</tr>
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</table>

Source: Moody’s, Bloomberg

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Current key credit drivers

Eesti Energia launched an offering of EUR 300 m 4.25% notes due on 2 October 2018. The transaction attracted a strong order book that exceeded EUR 650 m with 96 investors participating. The geographic allocation of the Notes was the following - Scandinavia and Estonia 39%, Switzerland 20%, Austria 12%, France 11%, UK 10%, Rest of Europe 8%, of which Fund managers comprised 41%, Insurance companies 36% Banks & Private Banks 15% and Pension Funds 8% of the total allocation. Closing and settlement of the offering was completed on 2 April 2012. The Notes were listed on the Main Market of the London Stock Exchange. The ESTONE 4.25 10/02/18 EUR note is currently priced at about 229 (Z-spread). The net proceeds of the offering will be used for Eesti Energia’s extensive CAPEX programme.

Investment case

- Eesti Energia generates 90% of Estonia’s electricity needs and some 17% of heating. Furthermore, the company owns and operates most of the distribution networks (infrastructure) in the country.
- Eesti Energia is 100% owned by the Government of Estonia (A1/AA-). The company also owns 100% of the country’s main supplier of oil shale, the long-term primary (domestic) fuel source in Estonia.

Key risks

- Increased costs as a consequence of the start of full auction of CO2-emission allowances in 2013.
- Increased competition and pressure on the group’s market position following the full opening of Estonia’s electricity market in 2013.
- Negative changes in the regulatory regime in Estonia.
- Significant changes in the ownership structure.

Recommendation

CDS: No recommendation

There are no credit default swap contracts outstanding with Eesti Energia as the reference entity.

Bonds: Overweight

The bond implied market rating (according to Moody’s methodology) of Eesti Energia is Baa3, i.e. two notches lower than the current long term rating. The ESTONE 4.25 10/02/18 EUR note is currently priced at about 205 (Z-spread). The ESTONE 4.5 11/18/20 EUR bond is currently priced at about 238 (Z-spread).

Given the rating and the solid ownership structure, we view this as quite an attractive price and our recommendation is over-weight.

Source: Moody’s, Bloomberg
Company profile

The dominant player in Estonia with historically strong financial profile

- Eesti Energia is operating mostly in the Baltic energy markets and is by far the dominant player in Estonia. The company operates in Estonia, Latvia, Lithuania, Finland, USA and also Jordan. Eesti Energia produces and sells electricity, heat and fuel (oil shale and shale oil) and provides customer and various consulting services. The major part of sales (73%) relates to electricity (regulated, unregulated and network operations), of which the larger part is unregulated sales. Regulation of prices on the regulated retail market will cease from 1 January 2013, after which all consumers will have the possibility to buy electricity from the unregulated market. The number of customers is nearing half a million, of these, approximately 470,000 are residential customers and 26,000 are business customers. Eesti Energia was established in 1939.

- More than 90% of the electricity produced in Estonia comes from oil shale, which is basically the only domestic energy source of any significance in the country. About 96% of Eesti Energia’s electricity production is based on oil shale. Oil shale can be used directly as a fuel for producing energy or for producing synthetic oil. The reserve of usable oil shale in Estonia is about 1–2 bn tonnes (estimates vary). A total of one bn tonnes of oil shale has been mined to date. Oil shale is extracted by opencast mining in the Aidu and Narva quarries and by underground mining in the Estonia and Viru mines. Eesti Energia is currently using around 15 m tonnes of oil shale per year for its energy production. The largest Estonian producer of electrical and heat energy is Narva power plants, owned by Eesti Energia, which provide around 95% of the electrical energy consumed in Estonia and supplies the whole town of Narva with heat.

- Oil shale is not a newly discovered energy source; it has been utilized around the world in various places and at various times for more than 150 years. But the high costs of oil shale extraction, together with the ready availability of conventional oil reserves, made the process uneconomic for most of the 20th century. However, a combination of high oil prices, improved extraction technologies, and increasing energy demands have reignited interest in the oil shale industry over the past few years, and a number of countries are currently seeking to establish major domestic oil shale markets and here Eesti Energia is a leading company.
Financial profile

Intensive CAPEX programme in progress

- Eesti Energia’s liquidity position is adequate, which is important given the extensive investment plan. It is supported by undrawn loan facilities of EUR 595m, of which EUR 500m can be taken into use until August 2014 and the decision regarding the undrawn loan facilities of EUR 95m must be made by December 2012. As of the end Q1 2012, EUR 25m of the EUR 500m credit facilities had been used. The group has a favourable maturity profile in that some 36% of the total debt is the EUR 4.5% bond due in 2020 (not including bond launched in April 2012), so the refinancing risk is low in the medium term.

- At the end of 2011, net debt stood at EUR 395m, having risen by EUR 273m during the year. The rise in net debt was caused by the substantial investment program as the company invested EUR 508m in 2011. The ratio of net debt to EBITDA also rose to 1.5 in 2011. The Group follows a strategy according to which net debt should not exceed EBITDA by more than three times and equity should be at least 50% of the total assets. The ratio of net debt to equity reached 32.8% at the end of 2011, a rise of 20.5% over the year.

- In 2012 the focus will be on implementing the capital expenditure program. Most of the investments will be covered by the bonds launched in April 2012. Also the approved Estonia state budget revealed an equity injection of EUR 150m this year, which is likely to materialise in the second half of the year. Total CAPEX is expected to amount to EUR 560m in 2012. In addition, the company would need to pay net dividends of EUR 65m (+tax) to the state budget this year. The liquidity situation going forward will be dependent on the cash flow generation capacity (which is currently strong), flexibility in CAPEX and the government’s attitude concerning support through capital injections.

- The EUR bond contains a put option linked to reduction of government ownership to below 51% should this result in a downgrading below investment grade.
Credit ratings

Moody's: Baa1/Stable (from A3/under review October 2011)

On December 19th, Moody's downgraded Eesti Energia's issuer rating from A3 to Baa1 and also the rating on the company's EUR 300m 4.5% bond due in 2020 from A3 to Baa1. The outlook on the ratings was set to stable. According to Moody's, the downgrade reflected the weakening financial profile caused by higher risk in its activities from the partial opening of the electricity market in Estonia. Also, further pressure could be expected on Eesti Energia's market position following the full opening of Estonia's electricity market in 2013. Moody's expects Eesti Energia's credit metrics to decline compared to previous years, given that the group faces increased pressure on its earnings and cash flows in conjunction with its very substantial investment programme.

The stable outlook is based on Moody's view that Eesti Energia's medium-term financial profile will reflect a gradual increase in leverage as investments are completed. The rating agency does not expect upward rating pressure in the intermediate term, unless Eesti Energia's credit metrics are improving on a more sustainable basis and the group is able to demonstrate that it can maintain its strong position following the full market opening in Estonia in 2013.

Overall, Eesti Energia's rating is underpinned by the company's strong position in the domestic market; Estonia's relatively benign regulatory regime; the company's excess generation capacity, which enabled it to export electricity within the Baltic region; and a historically strong financial profile, as reflected by moderate leverage and solid debt coverage metrics. The rating is, however, constrained by the growing unregulated activities of the group; its small size and ageing CO2-emission intensive generation portfolio; and its high level of capital expenditure, which is expected to weigh on its financial profile. The Baa1 rating of Eesti Energia incorporates uplift for potential government support to its standalone credit quality.

S&P: BBB+/Stable (from BBB+/Positive April 2011)

The ratings on Eesti Energia reflects the view of the "satisfactory" business risk profile, an "intermediate" financial risk profile and a "moderately high" likelihood that the Republic of Estonia would provide support in the event of financial distress. Furthermore, the rating is underpinned by an "adequate" liquidity position, the company's dominant position in the Estonian power market, the vertically integrated operations, its stable cash flow from regulated network activities and its adequate gearing and credit measures. On the negative side, the rating agency has brought out Eesti Energia's aging, fossil-fuel-intensive generation portfolio, which will be exposed to tightening CO2 constrains in the EU as of 2013, the company's exposure to volatile wholesale power markets and their expectation of significant negative discretionary cash flows and a continued gradual build-up of debt as a result of the company's plan to modernize its asset base and increase shale oil production. The rating agency sees limited upside rating potential due to the extensive investment program and challenging industry conditions. Any upgrade of the Republic of Estonia or a higher assessment of the likelihood of extraordinary government support could lead to an upgrade.

Credit strengths

- Strong market position as the leading vertically-integrated utility in Estonia.
- The regulatory regime is relatively benign in Estonia.
- Excess generation capacity enabling the company to export electricity to other Baltic countries.
- Strong financial profile expressed by e.g. moderate leverage and solid debt coverage metrics.
- Solid ownership structure with high probability of support from the government.
- In-house sourcing of fuel mitigating the risk for rising input costs.

Credit weaknesses

- The unregulated activities of the group are increasing its share of revenues.
- Small size from an international perspective.
- Generation capacity is very CO2-emission intensive, exposing the company to political risks in general terms and increased costs for CO2-emission allowances going forward. In the longer term this is a competitive disadvantage.
- High level of capital expenditures.
- Limited diversification both in terms of geography and assets.
- Very high dependence on the single fuel source oil shale.
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