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Research Update:

Eesti Energia Affirmed At 'BBB' On Adequate Liquidity; Outlook Negative On Expected Weaker Metrics After Nelja Deal

Primary Credit Analyst:
Anna Brusinets, Moscow +7 (495) 7834060; anna.brusinets@spglobal.com

Secondary Contact:
Elena Anankina, CFA, Moscow (7) 495-783-4130; elena.anankina@spglobal.com

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Overview

- Eesti Energia has secured an additional €300 million in credit facilities to support this year's planned acquisition of Nelja Energia AS, therefore alleviating previous liquidity concerns.
- Although we expect Eesti Energia's credit metrics to weaken following the acquisition, with funds from operations to debt declining to about 20%, we believe management will commit to recovery efforts from 2019.
- We continue to see a moderately high likelihood of Eesti Energia receiving extraordinary support from the Estonian government if needed.
- We are therefore affirming our 'BBB' ratings on Eesti Energia and its debt, and removing them from CreditWatch negative.
- The negative outlook reflects our expectation that the company's credit metrics will weaken following the acquisition and of challenges related to the execution of the company's plan to support metrics from 2019.

Rating Action

On Aug. 13, 2018, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on Estonia-based integrated energy utility Eesti Energia AS. The outlook is negative.

We also affirmed our 'BBB' issue ratings on Eesti Energia's senior unsecured debt.

At the same time, we removed these issuer credit and debt ratings from CreditWatch with negative implications, where we placed them on May 30, 2018.

Rationale

The rating actions point to our view that Eesti Energia has alleviated previous liquidity concerns by securing adequate funds for this year's acquisition of Nelja Energia AS, a Baltic renewable energy producer and developer. In addition, we believe that Eesti Energia is committed to supporting the recovery of its credit metrics after the acquisition, including potential cuts in capital expenditures (capex) or an IPO of a minority stake in its renewable generation segment. Nevertheless, we take into account that the company's credit metrics will likely deteriorate following the acquisition, to be completed by the end of 2018, and that the company may face challenges executing its plan to support metrics from 2019.

On May 29, 2018, Eesti Energia announced its intention to acquire 100% of Nelja Energia AS, which has installed wind capacities of about 287 megawatts (MW)--representing one-third of total capacity in the Baltics--and with €45 million EBITDA generated in 2017. The estimated consideration is €289 million and the enterprise value is assessed at about €500 million. Eesti Energia expects to close the deal by November 2018, which is the deadline for final clearance procedures.

Eesti Energia plans to fund the acquisition from substantial available cash balances (more than €300 million). In June 2018, the company obtained an additional €300 million in committed credit lines, resulting in a total of €450 million in credit lines. As such, we now believe that Eesti Energia will be able to maintain adequate liquidity, underpinning our current assessment of the company's 'bb+' stand-alone credit profile (SACP) and, in turn, the 'BBB' issuer credit rating.

We project that the transaction will lead to a temporary increase in Eesti Energia's debt leverage, with funds from operations (FFO) to debt declining to 20% in 2018, from about 25% currently. We view this decline as a trough, however. Because we understand that management is committed to deleveraging, we assume it will implement credit-supportive measures to facilitate recovery of its FFO-to-debt ratio to about 25%, which we view as commensurate with the current 'BBB' rating. Such measures could include an IPO of up to 49% of its renewable subsidiary Enefit Green, which has been discussed by the government for the past couple of years. Another measure could involve downsizing its investment program. Nevertheless, we do not rule out risks related to the execution of the company's recovery strategy.

In our view, Eesti Energia's business risk profile remains constrained by the company's relatively high-cost and environmentally unfriendly asset composition and fuel mix, risks related to potential tightening of environmental standards, and competitive and volatile wholesale power markets following the greater interconnection of Nordic and Baltic power market. We believe that, over the longer term, the evolution of Eesti Energia's creditworthiness will hinge on the company's ability to address these challenges.

Currently, Eesti Energia relies on oil-shale-based power plants. From 2019, the company plans on the conservation of generation units that have ran out of the allocated working hours as a result of which the annual energy generation capability will reduce by 2.5 terawatt hours (TWh)--23% of total oil-shale-based generation capability. The expected acquisition of Nelja Energia will increase the share of green energy (from wind, solar, biomass and waste) in Eesti Energia's total generation capability to approximately 15% from a currently low level of about 4%. We view the acquisition of Nelja as part of Eesti Energia's strategy to increase generation from renewable and alternative energy sources in assets portfolio up to 40% by 2021. We expect the Nelja acquisition will likely boost Eesti Energia's EBITDA by about €45 million per year, thanks to favorable tariffs on renewable energy set for six years (average remaining period of subsidized tariffs).

Despite its relatively high cost base, Eesti Energia aims to protect its earnings by targeting peak power production. This strategy might result in a price premium of up to 20% over the market price, supporting generation profitability. In addition, the company's vertically integrated shale oil operations, albeit being relatively small, reduce exposure to fuel price volatility. On the back of currently high oil prices, Eesti Energia's shale oil production segment generated 2017 EBITDA of about €23.9 million, and we expect it to report positive EBITDA in 2018-2019, thereby supporting credit metrics.

We consider that the main strength of Eesti Energia's business profile remains its ownership of most of Estonia's electricity distribution network. This asset contributes 35%-40% of the group's EBITDA and its stability helps mitigate the volatility from the shale oil production and power generation segments. In our view, the regulatory framework continues to provide predictability and support. However, there could be some pressure on the distribution tariffs because of declining weighted-average cost of capital (WACC), due to currently low interest rates. We understand there are proposals to revise WACC calculation, which if approved, could support the company's business risk profile and stronger cash flows from electricity distribution. However, we do not currently include any potential changes in our base case.

In our base case for Eesti Energia, we assume:

- Improving economic conditions in Estonia, with real GDP growth at 3.7% in 2018 and 3.4% in 2019.
- Nord Pool spot electricity prices for Estonia will remain closely aligned with Finnish prices. In 2017, the average day-ahead price in Nord Pool Estonia was €33.2 per megawatt hour (/MWh), including a premium of €0.03/MWh to prices in Finland. In the first half of 2018, the average day-ahead price in Nord Pool Estonia was €42/MWh. More than one-half of expected selling volumes for 2018 are hedged at €41.5/MWh.
- Conservation of old generation units from 2019 with total generation capabilities of 2.5TWh will be compensated by additional generation from Nelja Energia and increasing retail operations.
- Growth of electricity distribution volumes by 9% in 2018 compared with that in 2017, and remaining nearly flat in 2019. About 5% decrease of tariff in 2018 and a further 8% decrease of tariffs from 2019 to reflect the lowering WACC. However, revisions to WACC calculations, if approved, could support higher tariffs.
- Shale oil price at about €300 per ton, about 70% of expected shale oil sales volumes in 2018 are hedged at €256 per ton and about one-third at €261 per ton in 2019.

- Additional EBITDA of €40 million-€45 million annually generated by acquired assets.
- EBITDA margins of 28%-30% in 2018-2019, supported by currently favorable energy prices.
- Increased annual capex of about €280 million-€290 million in 2019 versus €200 million-€210 million in 2018. Capex for 2018 includes about €40 million of delayed spending from 2017. Higher capex in 2019 is attributable to developing renewable projects of about €130 million, which is not committed until 2019 and is subject to availability of funding.
- The drawdown of some available credit facilities to fund the Nelja acquisition. A €152 million Eurobond matures in October 2018 and could be fully repaid from available cash.
- Approved dividends of €16 million in 2018, moderate dividends of €10 million-€15 million in 2019.

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

- FFO to debt declining to 20% in 2018 after the Nelja acquisition, followed by possible recovery, hinging on the flexibility of the company's capex and the potential IPO.
- Debt to EBITDA of about 4.5x, recovering from 2019.

We continue to assess the likelihood of extraordinary government support to Eesti Energia as moderately high, based on our assessment of the company's:

- Strong link with the Estonian government, which currently owns 100% of Eesti Energia. We do not anticipate that the government's stake in Eesti Energia will fall below 50%; and
- 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.

The anticipated IPO of Eesti Energia's subsidiary does not affect our view of the likelihood of extraordinary support at this time. The IPO of a minority stake in Enefit Green of up to 49% was approved in the Estonian government's coalition agreement, as the government's strategy is to retain control of its government-related entities.

Liquidity

We consider Eesti Energia's liquidity to be adequate, based on our estimate that cash resources will cover outflows by more than 1.2x over the next 12 months, even if EBITDA declined by 15%. We also consider Eesti Energia's sound relationships with banks and satisfactory standing in credit markets.

Principal liquidity sources for the 12 months started July 1, 2018:

- About €319 million in available cash.
- Full availability under several committed revolving credit facilities totaling €450 million and expiring in July 2020 (€150 million) and June 2021 (€300 million).
- Our forecast of FFO of about €240 million-€250 million.

Principal liquidity uses over the same period include:

- Debt repayment of €170 million in 2018, including a €152 million Eurobond maturing in October; and about €18 million due in the subsequent 12 months.
- Capex of up to €250 million including up to €100 million related to the renewable development projects. However, these development expenditures are not committed until 2019 and are subject to availability of funding.
- Acquisition consideration of €289 million and €70 million of debt at Nelja, subject to acceleration with the change of control.
- Moderate dividends of about €10 million-€15 million.

We understand that Eesti Energia has financial covenants in some of its loan agreements. We assume that the company will act appropriately to ensure adequate headroom. We expect Eesti Energia will obtain waivers in 2018 if needed.

Outlook

The negative outlook reflects our view of implementation risks related to the execution of the company's plan to restore its credit metric after the Nelja Energia acquisition. We expect the company's credit metrics to weaken temporarily, with FFO to debt of about 20% in 2018, right after the acquisition of Nelja Energia.

We factor into our assessment, however, that the company appears to be committed to achieving FFO to debt of about 25% and debt to EBITDA of about 3x, which we view as commensurate with its current credit quality. We also expect ongoing and extraordinary support to the company from the Estonian government. Moreover, we believe that, over the next two to three years, risks from volatile power and commodities prices and relatively high costs of oil shale power generation will remain partly mitigated by the company's strategy to address electricity demand at peak hours, by additional EBITDA generated by acquired assets and relatively stable earnings from its regulated electricity distribution network.

Downside scenario

We could lower our ratings if we saw Eesti Energia's operating and financial performance deteriorating without prospects for near-term recovery, with FFO to debt falling sustainably below 25%. This would likely happen if the company could not adapt its capex plans, related to renewable strategy development, or financial policy accordingly. Pressure could also arise from tougher market environment and lower power prices, since we regard the company's ability to contain generation costs as limited, or from new large investment projects not included in our current base case.

We could downgrade Eesti Energia if we considered that its business risk position had weakened permanently due to a structural change in EBITDA generation, with a higher share of generally more volatile power generation and commodity trading business than regulated distribution, or weaker profitability.

Moreover, we would likely lower the rating if we saw a weakening of the Estonian government's ability or willingness to provide timely and sufficient extraordinary support to the company in the event of financial distress. Still, we see such a scenario as unlikely at this time.

Upside scenario

We could revise the outlook to stable if we observed a strengthening of Eesti Energia's credit metrics, with FFO to debt improving toward 25%, provided its business position does not weaken. This would most likely result from debt reduction efforts, or increasing oil and Estonian area power prices, an improving cost position for power generation, a substantially better generation-asset mix, and positive revisions to the regulatory framework for electricity distribution business.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/--

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)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)

- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Stand-alone credit profile: bb+

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

Issue Ratings--Subordination Risk Analysis

Capital structure

Eesti Energia's policy is to issue all debt at the parent company level. There is no financial debt at the operating subsidiaries.

Analytical conclusions

The 'BBB' issue rating on Eesti Energia's senior unsecured debt is in line with the issuer credit rating, since no elements of subordination risk are present in the capital structure. We will review this assessment following completion of the acquisition. We anticipate that the company would take measures to avoid any material structural subordination of debt.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated

Utilities Industry, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, 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

- Research Update: Estonian Power Utility Eesti Energia 'BBB' Ratings On CreditWatch Negative On Announced Plans To Acquire Nelja Energia, May 30, 2018

Ratings List

Ratings Affirmed; CreditWatch Action

	To	From
Eesti Energia AS		
Issuer Credit Rating	BBB/Negative/--	BBB/Watch Neg/--
Senior Unsecured	BBB	BBB/Watch Neg

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com