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Ratings

Research

Research Update:

Estonian Power Company Eesti Energia AS Rating Affirmed At 'BBB'; Outlook Negative

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Research Update:

Estonian Power Company Eesti Energia AS Rating Affirmed At 'BBB'; Outlook Negative

Overview

- Low power and oil prices continue to pressure Estonian power company Eesti Energia's operating cash flows, mitigated by the company's stable income from network operations and its cost reductions.
- We continue to assume a moderately high likelihood of extraordinary support from the Estonian government, if needed.
- We have affirmed our rating on Eesti Energia at 'BBB'.
- The negative outlook reflects the increasingly tough industry conditions and falling prices for most of Eesti Energia's businesses, which put pressure on our view of Eesti Energia's business and financial risks.

Rating Action

On June 17, 2016, S&P Global Ratings affirmed its 'BBB' long-term rating on Estonian power company Eesti Energia AS and its issue ratings on the existing debt. The outlook is negative.

Rationale

We consider that Eesti Energia's business risk is supported by its ownership of most of the electricity distribution network in Estonia. This asset contributed around 40% of group earnings in 2015 and its stability helps to mitigate the volatility from Eesti Energia's shale oil production and power generation segments. The full-cost cover of the regulatory framework continues to provide predictability and support, although there is no set regulatory period, and the tariff is fixed until an application from the operator is submitted for review.

In our view, Eesti Energia's power generation remains increasingly exposed to competitive and volatile wholesale power markets following the greater interconnection of Nordic and Baltic power markets. In addition, its fossil-fuel-intensive generation portfolio exposes the group to potentially higher costs for carbon emissions, and competition from more-efficient power production from Nordic countries.

Eesti Energia benefits from its vertically integrated oil-shale operations, which reduce fuel price volatility. Over the past few years, the company has worked to increase the value added from the group's oil-shale resources by increasing its shale oil production. However, we consider that the group's competitive position in this area is constrained by its small-scale operations. The volatility of this business has been demonstrated in recent

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years by the drop in oil prices, which put significant pressure on the profitability of these operations.

However, Eesti Energia benefits from a material amount of free carbon emission allowances that are associated with the construction of a new power plant. This plant is intended to reduce the group's future carbon emissions. Eesti Energia is supporting its earnings by scaling back production, but targeting peak power production. This strategy could give it a price premium over the market price of about 5%-20%. Eesti Energia also maintains a strong retail market share--it continues to hold 60% of the retail market share in Estonia and about 25% in the Baltics.

We see Eesti Energia's financial risk as significant, given our expectation that credit measures will continue to weaken over the next two years. We expect funds from operations (FFO) to debt to fall to between 20%-25%. In the short term, the group's power and oil price hedges have partially mitigated the decline in lower prices. However, as the hedges come to an end over the next two years, we anticipate that the risk to the company's earnings profile could increase. In our view, the contribution of earnings from the distribution network provides a more stable earnings base, mitigating the pressure on power and oil prices.

Eesti Energia's significant investments aimed at modernizing its generation fleet and increasing its shale oil production have contributed to a high debt level. That said, we anticipate lower investments in the next few years, and we also assume that any new large investments would only be made if it is supported by a capital injection from the Estonian government. We see this as important for credit protection, as Eesti Energia's metrics do not indicate that it has the capacity to support further growth investment.

Under our base case, we assume:
- Revenues declining over the forecast period;
- EBITDA margins of about 30%; and
- Capital expenditure around €170 million-€180 million in 2016 and 2017.

Based on these assumptions, we arrive at the following credit measures for 2016 and 2017:
- FFO to debt of about 20%-25%; and
- Debt to EBITDA of approximately 3.1x-3.7x.

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 was to face financial distress. This is based on our assessment of Eesti Energia's:
- Strong link with the Estonian government, its sole owner. The government currently owns 100% of Eesti Energia and we do not anticipate that the government's stake in Eesti Energia will 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.

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Liquidity

We consider Eesti Energia's liquidity to be adequate, based on our estimate of the group's cash resources covering cash outflows by more than 1.2x over the next 12 months. We also take into account 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%. We factor into our liquidity assessment for the next 12 months, our estimates as of the first quarter of 2016:

We anticipate the company will have the following principal liquidity sources over the next 12 months:

- About €160 million in available cash.
- Full availability under three committed bilateral revolving credit facilities that total €150 million.
- Our forecast of FFO of about €200 million.
- Working capital inflows of €2 million.

We anticipate the company will have the following principal liquidity uses over the same period:

- Minor debt repayment of about €19.3 million.
- Capital expenditures of about €167.6 million.

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, and take any appropriate measures to ensure adequate headroom under the covenants should operating cash flows reduce more than currently anticipated.

Outlook

The negative outlook reflects the increasingly tough industry conditions and falling prices for most of Eesti Energia's businesses, especially its shale oil operations, which we anticipate will lead to a contraction in earnings and credit measures over the next two years. We assume, however, that Eesti Energia should continue to benefit from stable earnings from its regulated electricity distribution network. In addition, we continue to factor into the ratings both ongoing and extraordinary support to the company from its 100% owner, the Estonian government.

Downside scenario

We could lower our rating on Eesti Energia within the next two years if we expected that credit measures would fall below our expectations for the ratings without any anticipated near-term recovery. This includes a ratio of FFO to debt of below 20%. We could also lower the rating if we considered that Eesti Energia's business risk had weakened permanently as a result of the tougher market environment. Moreover, we would likely lower the rating if we revised downward our current assessment of the moderately high likelihood that the Estonian government would provide timely and sufficient extraordinary

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government support to the company in the event of financial distress.

Upside scenario

We could revise the outlook to stable if we observe that Eesti Energia's credit metrics had stabilized and show a clear path to being maintained at above 20% FFO to debt and debt to EBITDA of about 3.5x, and we consider that its current business position is stable. This could, for example, be shown by stabilizing or improving oil and Estonian area power prices.

Ratings Score Snapshot

Corporate 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)
- 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
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 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
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013

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- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, 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

Ratings List

Ratings Affirmed

Eesti Energia AS	
Corporate Credit Rating	BBB/Negative/--
Senior Unsecured	BBB

Additional Contact:
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