

Research Update:

# Estonian Eesti Energia Outlook Revised To Negative On Expected Weaker Metrics; 'BBB-' Ratings Affirmed

August 27, 2020

## Rating Action Overview

- We expect low power prices in Estonia, pandemic-related economic slowdown, and declining electricity generation as a result of high CO2 prices to pressure Eesti Energia's credit metrics in 2020, notably with funds from operations (FFO) to debt weakening below 20%.
- At the same time, equity injections from the Estonian government (€125 million in second-quarter 2020--matched with the company's commitment to recovery efforts and planned IPO of its renewables subsidiary--could help mitigate this effect.
- We continue to see a moderately high likelihood that Eesti Energia would receive extraordinary support from the Estonian government if needed.
- We are revising our outlook to negative from stable and affirming our 'BBB-' ratings on Eesti Energia and its debt.
- The negative outlook indicates that we could lower the ratings if FFO to debt remained below 20% without any prospects for recovery over the next two years.

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## Rating Action Rationale

**We expect 2020 EBITDA to decline by 15%-20% and FFO to debt to remain below 20%.** In our view, low power prices in Estonia, economic slowdown, and lower generation volumes will hit Eesti Energia's credit metrics in 2020, following already weak 2019 performance. We expect Eesti Energia's EBITDA to decline from €260 million in 2019 to €200 million-€210 million in 2020, and FFO to decline from €218 million in 2019 to €170 million-€180 million in 2020. Based on these assumptions, we expect FFO to debt to be below 20% during 2020-2021 (around 17% to 20%) and debt to EBITDA to be around 4.5x-5.0x in 2020. We also expect discretionary cash flows (operating cash flow after capital expenditure [capex] and dividends) to debt to remain broadly neutral due to limited investments.

Eesti Energia's 2020 results have been weakened by the COVID-19 pandemic, economic slowdown, and unusually high water levels at hydro power plants after an extraordinarily warm and rainy winter resulted in oversupply and pressure on electricity prices and demand.

Average Nord Pool System Prices during January to July 2020 have declined by 77% to €9.3 per megawatt hours (/MWh) from €40.4/MWh compared with the same period in 2019. Even though Estonia did not experience the same magnitude of decline, Nord Pool Estonia's average price for the same period dropped to €28.5/MWh, 38% lower than the previous year. We expect recovery in power prices from 2021 of close to €40/MWh, which should provide some upside in the electricity generation segment.

The COVID-19 pandemic and subsequent economic slowdown has also led to lower electricity consumption. We now expect the Estonian economy to enter recession, with real GDP declining by almost 7% and then rebounding back to about 5% in 2021 (see "Estonia Outlook Revised To Stable From Positive On COVID-19-Related Risks; 'AA-/A-1+' Ratings Affirmed," published on Aug. 21, 2020).

The ongoing decommissioning of plants in Estonia's Narva region--as they are expensive to run and environmentally unfriendly--coupled with lower electricity consumption, has resulted in lower expected volumes of electricity sales and distribution. In 2020, we expect volumes of electricity sales to fall by around 5% and electricity distribution by about 3%, compared with 2019 levels. We then anticipate recovery of 18% for sales and around 4% for distribution in 2021.

**If it goes ahead, the planned IPO could lead to a substantial recovery in credit metrics as early as 2020.** Eesti Energia has been preparing to publicly list a minority stake of its renewable subsidiary Enefit Green for more than a year. Even though we believe that both the company and its sole shareholder are highly committed to the IPO, we do not include the potential proceeds from the listing, nor the related expansion capex in our base case. This is because of the remaining uncertainty around timing and execution, exacerbated by current market volatility caused by the COVID-19 pandemic. If the IPO materializes, we expect Eesti Energia's FFO to debt to remain above our 20% threshold for the current rating level even after factoring in additional capex. At the same time, we forecast discretionary cash flow to debt will remain largely negative, mainly due to sizable capex.

We understand that the IPO has been delayed, but the preparations are ongoing. If and when it goes ahead, the proceeds will likely be used to fund renewables expansion. Eesti Energia and its controlling shareholder, the government of Estonia, have made a strategic commitment to expand their share of renewables generation. The substantial investment plan will benefit the environment and also support long-term competitiveness and security of supply. The Estonian government's strategy is to increase its share of electricity produced from renewable sources to at least 40% by 2030, from the current 30%.

Investing further in renewables should help Eesti Energia to retain long-term competitiveness and reduce its exposure to volatile Nord Pool prices via renewable power purchase agreements or a favorable subsidy scheme, particularly if state support for green energy remains strong. Eesti Energia has also considered investing in the shale oil business, which we view as risky and volatile. That said, we expect this investment's contribution to EBITDA will be limited before 2024, when we expect the new oil plant (Enefit 280-2) to be fully operational resulting in an increase in EBITDA from the shale oil business.

**The group's importance to the Estonian government and ownership of most of Estonia's electricity distribution network continues to underpin the rating.** We see Eesti Energia as highly important to Estonia, given its crucial role in the electricity and shale oil markets. This is

also confirmed by the €125 million equity injection completed in second-quarter (Q2) 2020, the government's support for the group's strategy, and its decision not to extract any dividends from the company in 2020.

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, which we don't expect to change.
- Important role for the government, given that Eesti Energia's operations are strongly aligned with the government's interests, in particular in ensuring that Estonia is self-sufficient in electricity.

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

**Stable regulated electricity network distribution business continues to support the rating.** The main support for Eesti Energia's business risk profile is 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 oil-shale production and power generation segments. The regulatory framework continues to provide predictability and is based on generally used principles of a return on a regulatory asset base. Since 2013, the regulator has adopted a light-touch approach and there are no set regulatory periods; the company may apply for a change in tariffs if it believes they are justified. The average tariff declined on average 8.0% in 2019 compared with 2018 when EBITDA declined to around €80 million from around €100 million. We expect the tariff to remain flat in 2020, resulting in a roughly €80 million contribution from this segment.

## Outlook

The negative outlook reflects our expectation that in 2020, Eesti Energia's FFO to debt will weaken below 20%, which is below our threshold for a 'bb' stand-alone credit profile. We also assume that the company's liquidity will remain adequate. We exclude potential IPO proceeds from our base case.

We factor into our assessment, however, that the company appears to be committed to maintaining an investment-grade rating, notably achieving FFO to debt of above 20%, which we view as commensurate with its current credit quality. We also expect ongoing and extraordinary support to the company from the Estonian government, no pressures on liquidity, and no issues with maturities rollover or covenant renegotiation/waivers.

Absent an IPO and related capex, and including only gradual recovery in operating metrics, we expect FFO to debt of 17%-20% and neutral discretionary cash flow to debt in 2020-2021.

## 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 20%. Weakening liquidity and any issues with covenant waivers (which we currently do not expect)

could also pressure the rating.

## **Upside scenario**

We could revise the outlook to stable if we observed that Eesti Energia's credit metrics had stabilized, and looked likely to stay above 20% FFO to debt, provided that its business position does not weaken. This would most likely result from:

- Successful execution of the IPO;
- Stronger operating results, thanks to increasing Estonian area power prices, operating efficiencies for power generation, or positive revisions to the regulatory framework for electricity distribution business; or
- Strengthening of the government's ability or willingness to provide timely and sufficient support to the company.

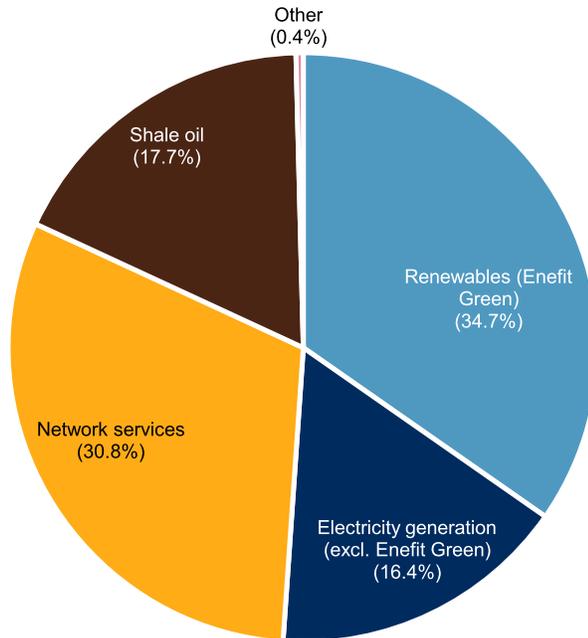
## **Company Description**

Eesti Energia is a vertically integrated energy company that is 100% owned by the Estonian government. By EBITDA, its operations are split as follows:

- About 45%-50% from electricity and heat generation and the supply of electricity in Baltic countries;
- About 40% from regulated electricity distribution in Estonia; and
- 15%-20% from shale oil production and other services.

Chart 1

### Eesti Energia AS 2019 EBITDA Structure



Source: Eesti Energia AS, Enefit Green.  
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Eesti Energia operates in the electricity and gas markets of the Baltic countries, Poland, and Finland. It also operates in the international liquid fuels market. Its energy offering includes electricity, heat and fuel production, sales and customer services, and other energy services.

## Our Base-Case Scenario

### Assumptions

- GDP growth in Estonia at -6.8% in 2020 and 5.1% in 2021, a slowdown from 4.0% in 2019.
- Average electricity price in the Estonian segment of Nord Pool of around €30/MWh in 2020, with recovery to €40 in 2021.
- We expect lower volumes of electricity sales (by 5%) in 2020 mainly due to the COVID-19 pandemic and economic slowdown in Estonia. Volumes are expected to recover starting from 2021, thanks to higher demand and additional renewable generation.
- Average distribution tariff to remain flat at 2020, at the same level as 2019 and to contribute around €80 million.
- Weighted-average cost of capital approved by the Competition Authority and applied to the

electricity network distribution business is 4.61% from 2020 (up from 4.5%) as average rate of return on the benchmark instrument (10-year German bond) over the past five years was replaced by average rate of return over last 10 years.

- Additional renewables generation and further expansion of the retail segment will continue to partially compensate for declining generation due to the conservation of old units.
- Average shale oil sales price at around €300/ton through 2021 (note: our Brent price assumption is \$50/bbl in 2021, \$55 thereafter). Shale oil volumes to be sold in Q3-Q4 are almost fully hedged at €315/ton.
- EBITDA margin to decline from 27.2% in 2019 to 20%-22% during 2020-2021 based on the higher share of retail operations.
- Capex of around €170 million-€200 million during 2020-2022. This does not include expansion capex to be funded with IPO proceeds.
- No dividends in 2020 and 2021.
- Due to high uncertainties caused by COVID-19, we do not include IPO proceeds, as well as expansion capex, which the company plans to fund with the IPO.

## Key metrics

Table 1

### Eesti Energia Key Metrics\*

(Mil. €)	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020e	2021f	2022f
EBITDA, EUR mln	278.3	260.4	200-210	230-240	265-275
EBITDA margin (%)	31.8	27.2	22-24	20-22	19-21
Capital expenditure, EUR mln	169.9	143.4	170-180	180-190	200-210
Debt to EBITDA (x)	3.9	4.3	4.5-5	4-4.5	3.5-4
FFO to debt (%)	21.4	19.3	17-19	18-20	19-21
DCF to debt (%)	(1.3)	(4.3)	0-(1)	(1)-(2)	(3)-(4)

\*All figures adjusted by S&P Global Ratings. §2019 year-end debt consists of net financial debt of €1098.2 mil. with key adjustments being €3 mil. in leases, €5.2 mil. in pension and €23.3 mil. in ARO. a--Actual. e--Estimate. f--Forecast.

## Liquidity

We consider Eesti Energia's liquidity to be adequate based on our estimate that cash resources will cover outflows by 1.2x over the next 12 months, starting from June 30, 2020. 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, 2020:

- Cash and cash equivalents of €134 million.
- Undrawn committed credit lines of €270 million maturing in more than one year from July 1, 2020.
- Our forecast of cash FFO of around €190 million.

Principal liquidity uses include for the same period:

- Override debt maturities of €342 million.
- Capex of around €110 million.
- No dividends scheduled.

## **Covenants**

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

## **Issue Ratings--Subordination Risk Analysis**

### **Capital structure**

Eesti Energia's policy is to issue all debt at the parent company level. Total outstanding debt as of June 30, 2020 stood at €1,132 million. After the Nelja acquisition, the operating subsidiary will carry around €223 million of debt, equivalent to about 20% of total debt.

### **Analytical conclusions**

The 'BBB-' issue rating on Eesti Energia's senior unsecured debt is in line with the issuer credit rating, because no elements of subordination risk are present in the capital structure.

## **Ratings Score Snapshot**

Issuer Credit Rating: BBB-/Negative/--

Business risk: Satisfactory

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

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

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-
- Likelihood of government support: Moderately High (+2 notches)

## 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: 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## Related Research

- Estonia Outlook Revised To Stable From Positive On COVID-19-Related Risks; 'AA-/A-1+' Ratings Affirmed, Aug. 21, 2020

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Eesti Energia AS</b>		
Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--

**Ratings Affirmed; Outlook Action**

	To	From
Senior Unsecured	BBB-	BBB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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