Research Update:

Estonian State-Owned Eesti Energia 'BBB-' Ratings Affirmed; Outlook Remains Negative

October 28, 2021

Rating Action Overview

- Eesti Energia AS' IPO of its subsidiary, Enefit Green AS, resulted in the listing of 22.8% of shares for €175 million. Following the IPO, Eesti Energia plans to broadly double its investments, to €1,400 million in total between 2021 and 2024, mainly to increase its renewable energy capacity, to 1.1 gigawatts (GW) in 2025 from 0.5 GW in 2020.
- We forecast credit ratios will remain in the lower range of the expectations for the rating in 2022, with funds from operations (FFO) to debt close to 20%, since proceeds from the IPO won't cover the massive capital expenditure (capex) increase to about €400 million annually, up from about €170 million in 2020. However, we anticipate that Eesti Energia's financial position will recover in 2023.
- We therefore affirmed our 'BBB-' ratings on Eesti Energia and its debt.
- The negative outlook reflects the risk of a downgrade if Eesti Energia cannot maintain its financial position, notably FFO to debt sustainably above 20%.

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Rating Action Rationale

We assume investment of €450 million- €500 million annually in 2022 and 2023, leading to negative free operating cash flow of €150 million-€300 million each year. Following the successful IPO of Enefit Green, the group now plans to increase its investments significantly. We assume capex will increase to about €1,400 million between 2021 and 2024, which is a massive increase from previous run-rate investment of about €150 million annually. About 50% of investment will go into renewables, including solar and wind at Enefit Green, and about €300 million into a new shale-oil plant. Eesti Energia also aims to continue to invest about €55 million-€60 million annually into its grid operations. The massive increase in investment will start to have an impact on EBITDA a few years later, as renewable projects and increased shale-oil production enter operation. We expect EBITDA generation from renewables will increase to about €130 million from 2024, from about €80 million currently.

The IPO proceeds of €175 million, together with internally generated cash flows, will not cover the ambitious capex program. We therefore anticipate debt will increase to almost €1,250 million by 2023, from about €900 million currently, if no additional remedy measures are imposed. Consequently, we expect FFO to debt will be slightly below the 20% rating threshold in 2022 before recovering somewhat in 2023 to about 20%. That said, the company has in the past over-guided expected spending, and we also note that a fairly large share of the planned capex remains uncommitted. This implies there could be some upside potential for the credit ratios, although we expect them to be at the very low end for the rating.

After the IPO, the group structure is more complex, with debt both at Eesti and Enefit, while cash flow from renewables will be diluted, given the 22.8% minority, but the funds will enable a major step in green investments. Enefit Green is a cornerstone of the group's strategy to reach its target to increase the share of electricity from renewable sources to at least 80% by 2030. This would be driven by offshore wind parks and realization of Enefit Green's long-term project pipeline. By 2025, the share of renewable electricity production is expected to reach 55%. Enefit Green has been listed on Nasdaq since Oct. 21, 2021. The total gross proceeds of the IPO were approximately €175 million, of which approximately €100 million went to Enefit Green and approximately €75 million to Eesti Energia. As 22.8% of Enefit Green has been listed, there is now a minority claim on future cash flow from Enefit Green, which we see as marginally diluting the impact of Eesti Energia's renewables strategy. We continue to fully consolidate Enefit Green in our analysis, as we expect the proportional de-consolidation effect to have a minor-to-modest impact only and since Eesti has full control of Enefit Green through the board of directors and thereby can modify, among others, investment level and dividend policy. There is no material difference in credit ratios compared with a proportional de-consolidation of Enefit Green. This is because debt will be raised both at Enefit Green and Eesti Energia level in the future. The group structure will, however, be more complex, and Eesti will have limited access to the cash at Enefit Green. It also introduces subordination risk for Eesti, but we expect the ratio to remain below 50% in the coming year. On the positive side, we believe that, thanks to the IPO, Eesti Energia has been able to increase the renewables investments at a higher speed and at a higher level within the current rating level.

Despite its strategy to reduce CO2, emissions remain high. Enefit Green is aiming to finance the company's near-term pipeline of up to 600 megawatts (MW) of wind and solar projects, supporting its 1.1-GW renewable capacity target by 2025, up from 457 MW of current capacity. Although this is a sizable improvement of renewable capacity, Eesti Energia will continue to be dependent on generation from shale oil. Eesti Energia's emissions remain higher than many rated peers, at about 367 gram emissions per KWh (g CO2/KWh) for its total energy production and 550 g CO2/KWh for electricity production. This ranks Eesti Energia at about same levels as ESB (378 g CO2/KWh) and EnBW (372 g CO2/KWh) but with higher pollution compared with CEZ (330 g CO2/KWh) and Fortum including Uniper (320 g CO2/KWh).

Electricity generated from shale oil is not expected to be phased out until 2030. Since shale oil is highly polluting, the company has a large exposure toward the price of CO2 emission allowances. Nevertheless, we believe that successful reduction in CO2 emissions in recent years makes the company much less exposed to increased CO2 allowance prices, as old electricity generation with a high environmental footprint has been phased out. We don't expect further reduction in CO2 emissions to continue in absolute figures, but because Eesti Energia's renewable electricity generation will increase, the share of CO2 measured to electricity produced will continue to decrease.

The stable regulated electricity network distribution business continues to strongly support the rating, offsetting the proportional impact of Enefit Green's minority. While we view the introduction of a minority stake in Enefit Green as moderately negative for Eesti Energia' business risk profile, since most of the more polluting generation will remain in Eesti Energia, the business risk profile remains supported by the ownership of most of Estonia's electricity distribution network which is a key infrastructure to provide electricity to the country and provides very stable and predictable cash flow. This asset contributes 35%-40% of the group's EBITDA on a consolidated basis, and its stability helps mitigate the volatility from the shale-oil production and power generation segments. The regulatory framework continues to provide predictability and is based on generally used principles of return on regulatory asset base (RAB). 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. We expect the tariffs to gradually increase, as a result of increasing RAB. We expect the EBITDA contribution from distribution system operator (DSO) activities to increase gradually year on year, and to exceed €100 million by 2024.

The group's importance to the Estonian government continues to underpin the rating. We see Eesti Energia as highly important to Estonia (AA-/Positive/A-1+), given the company's crucial role in the electricity and shale-oil markets. This is also confirmed by the €125 million equity injection completed in second-quarter 2020, the government's support for the group's strategy, and its decision not to extract any dividends from the company in 2020 and 2021. 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 Enefit Green IPO 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.

Outlook

The negative outlook reflects our expectation that Eesti Energia's FFO to debt will stay above the 20% threshold in 2021, mainly because of the IPO proceeds, and will be only temporarily below 20% in 2022. This is because of the anticipated capex increase, which we forecast will lead to negative cash flows in 2022 before FFO to debt returns above 20% in 2023. Fully excluding Enefit Green from Eesti Energia's financials, leverage is temporarily higher: We expect debt to EBITDA to peak at about 5x by year-end 2022 as a result of ongoing investments, before decreasing toward 4x by 2023, and then declining further, as the main investments and debt are expected at Enefit Green. Despite the expected rapid debt increase at Enefit Green, we expect that subordination risk will be managed and debt at the subsidiary will remain well below 50% of total group debt.

We factor into our assessment that the company appears to be committed to maintaining an investment-grade rating, notably achieving FFO to debt of above 20%. We also expect ongoing and extraordinary support to the company from the Estonian government, no pressure on liquidity, and no problems with rollover of maturities or covenant renegotiation/waivers.

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% for a prolonged time. Weakening liquidity could also pressure the rating, although this is not expected. We could also lower the rating if the company undertook additional debt-financed investments.

In addition, a further increase of the minority stakes could add rating pressure if at the same time this led to more pronounced differences between full consolidation and proportional consolidation of Enefit in the credit ratios. This is not our base case, however.

Upside scenario

We could revise the outlook to stable if Eesti Energia's credit metrics stabilizes, with FFO to debt above 20% on a sustainable basis, provided that its business position does not weaken. This could be result of:

- Divesting additional shares of Enefit Green to finance its capex program, or
- A successful ramp-up of investment, without delays or cost-overruns
- 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.

Company Description

Eesti Energia is a vertically integrated energy company based in Estonia, with operations mainly in the Baltics, but also in Finland, Poland, and the U.S. Eesti Energia is 100% owned by the Estonian government. The group's main operation areas are, electricity generation with about 3.8 TWh of generation, shale oil production of about 452,000 metric tonnes, electricity distribution with 93% coverage in Estonia, and customer solutions. Reported EBITDA amounted to €214 million in 2020. On average: about 35%-40% 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.

Our Base-Case Scenario

Assumptions

- Real GDP in Estonia to expand by 5.5% in 2021, 4.8% in 2022, and 2.9% in 2023, benefitting from strong external demand and fiscal support.
- Subsidiary Enefit Green to be 100% consolidated, although minority share of 22.8% is divested.
- IPO amount of €175 million received in 2021.

- Nord Pool electricity price in Estonia on average at €60-€80 per MWh in 2021-2023.
- Electricity generation: Renewable generation at about 1.1 TWh in 2021 and 2023, then increasing to about 1.7 TWh in 2023. Thermal generation at about 4.4 TWh in 2021, then decreasing toward 3.4 TWh because of closing of old thermal plants.
- DSO activities: Average distribution tariff to remain stable during 2021 to 2023. Increased volumes of electricity distribution (by 3%) in 2021 and another 5% in 2022 as volumes are expected to recover starting from 2021.
- Shale oil price including hedge on average at €280 per tonne, and a production of about 450,000 tonnes annually in 2021-2023.
- EBITDA margin of 19%-23% during 2021-2023.
- Capex of about €300 million in 2021, then about €500 million annually in 2022 and 2023.
- Government grants related to new shale oil production plant of about €114 million received during 2022.
- No dividends in 2021, then about €20 million-€40 million annually in 2022 and 2023. Including dividends paid from Enefit Green to minority shareholders.

Key metrics

Mil. €	2020	2021p	2022e	2023f
EBITDA	204.6	210-220	210-230	290-310
FFO	179.6	200-210	190-210	260-280
Capex	173.6	240-260	400-450	400-450
Debt	873.9	800-850	950-1,050	1,150-1,250
FFO to debt	24.7	22-26	18-22	20-24
Debt to EBITDA	4.3	3.3-3.8	4.2-4.7	4.0-4.5

Figures include S&P Global Ratings' adjustments. p--Planned. e--Estimated. 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 Sept. 30, 2021. We note that Eesti Energia and Enefit Green have separate financing, implying Eesti Energia can't freely access cash at Enefit Green. Eesti Energia has sources over uses (both consolidated and stand-alone) above 1.2x over the next 12 months. The debt maturity profile is however relatively concentrated, as Eesti Energia has a €500 million bond that matures in September 2023. We understand management plans to refinance the bond during the first half of 2022.

We view Eesti Energia's relationships with banks as sound, and its standing in credit markets satisfactory. This is further enhanced by the ownership of the majority DSO operation in Estonia, which is a critical infrastructure with typically very stable cash flows. The recent IPO demonstrates market access. Following the IPO there have been important changes in the liquidity set up, since Eesti Energia can't freely access the cash and credit facilities at Enefit Green. In our analysis, we therefore exclude those sources.

Principal liquidity sources include:

- Cash and cash equivalents of about €150 million. This figure excludes €14 million of cash at Enefit Green level.
- Undrawn committed credit lines of €625 million. This figure excludes undrawn facilities with maturities below one year and the facilities arranged at Enefit Green level.
- Our forecast of cash FFO of about €200 million
- IPO proceeds of €175 million.

Principal liquidity uses include:

- Debt maturities of about €80 million.
- Capex of about €460 million.
- Working capital outflow peaking at about €100 million.
- No dividends.

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, 2021, stood at €961 million. Enefit Green has outstanding debt of €185 million, equivalent to about 19% 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: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: 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: Industry Risk, 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
Eesti Energia AS	
Issuer Credit Rating	BBB-/Negative/--
Senior Unsecured	BBB-