Research Update:

Eesti Energia AS 'BBB-' Ratings Affirmed; Outlook Negative

November 24, 2022

Rating Action Overview

- Realized power prices for Eesti Energia are likely to exceed €200 per megawatt hour (/MWh) in 2022, up from about €77/MWh in 2021, which will lift EE's earnings and cash flows through 2024. Power prices have structurally shifted upward, and we now expect Eesti Energia to post S&P Global Ratings-adjusted EBITDA of more than €550 million in 2022, up from €270 million in 2021. We expect funds from operations to debt (FFO) to massively increase to about 70%, well above our previous assumption of about 30%
- Eestia Energia intends to increase installed renewable generation capacity. It will do this by increasing its investments to about €2.5 billion-€3.0 billion over 2022-2026 and by building a third shale oil plant. This will translate into larger exposure toward market prices and generation volumes, and we therefore think cash flows will be more sensitive to volatility. We have therefore revised upward the stand-alone credit profile (SACP) threshold for FFO to debt to 25% from 20% previously.
- We continue to see a moderately high likelihood that Eesti Energia would receive extraordinary support from the Estonian government if needed.
- We affirmed our 'BBB-' issuer credit rating on Eesti Energia and our 'BBB-' issue rating on its debt.
- The negative outlook reflects the risk of a downgrade if Eesti Energia did not successfully refinance its €500 million bond maturing in September 2023, putting pressure on the company's liquidity.

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Rating Action Rationale

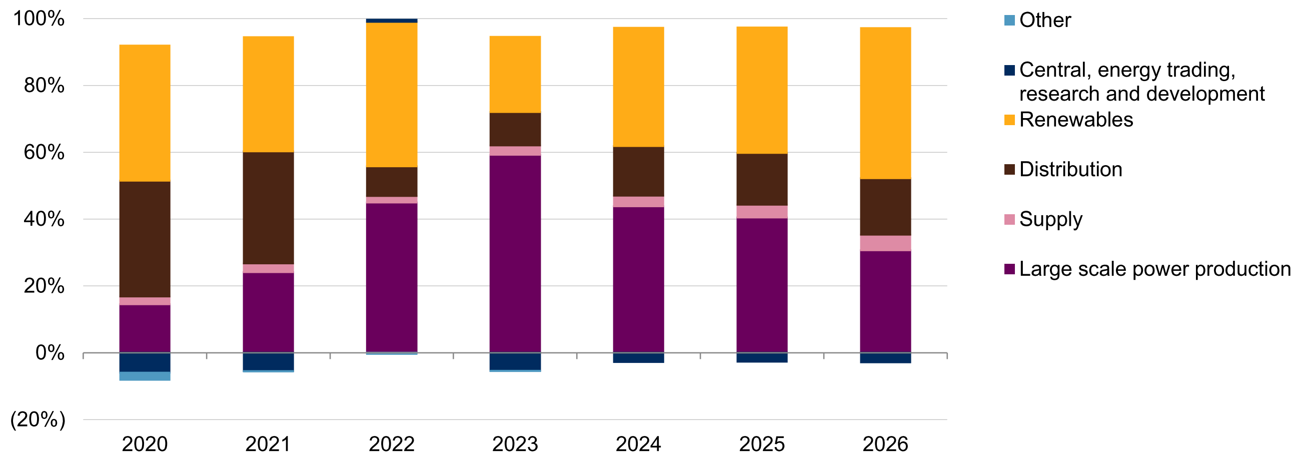
Financial performance at Estonia-based Eesti Energia is benefiting strongly from the ongoing rise in power prices, enabling it to build ratings headroom. The energy crisis triggered by the Russia-Ukraine conflict has made gas and power prices across Europe extremely volatile. We now expect power prices to remain high until at least 2024. Europe's dependence on Russian gas has been exposed and, in our view, the European energy market is therefore unlikely to return to the pre-conflict status quo after the conflict ends. We now see structural support for higher and more volatile power prices over a longer period. In Estonia, power prices has averaged €205/MWh during 2022, compared with €86.73/MWh during 2021, largely a consequence of the tight power market.

In our view, Eesti Energia is well placed to take advantage of the higher prices. We expect a solid improvement in EBITDA to about €500 million-€550 million per year in 2022 and 2023, up from €270 million in 2021, since Eesti Energia's' unhedged generation portfolio is benefiting from the elevated electricity prices. Electricity prices have been significantly higher during 2022, averaging about €205/MWh in Estonia in 2022 compared to €86.73/MWh in 2021. Due to the elevated energy prices, the company has also increased the power output from its hybrid thermal, mostly oil shale-fueled plants by 48% year on year in the first nine months of 2022, with biomass and shale gas contributing to about 17% of the fuel mix. This has translated into improved cash flows from Eesti Energia's generation portfolio. We now expect Eesti Energia's credit ratios to benefit from elevated electricity prices, with FFO to debt peaking at the end of 2022 and then stabilizing afterward at 32%-35% during 2023-2024. We note that peak at the end of 2022 is primarily due to Eesti Energia's accumulated cash balance, which resulted in materially lower net debt of €760 million. At this stage, there has been no discussion about any windfall taxes in Estonia, despite the increased profitability and cash flow of Eesti Energia. We also understand dividends will follow the existing dividend policy stipulating a 50% payout.

The ambitious investment plan is likely to result in diluted share of earnings from regulated activities and increase the company's exposure to market prices and electricity generation volumes. The company's strategy entails investment of about €2.5 billion-€3.0 billion over five years (2022-2026). We understand Eesti Energia will direct the majority of the investments into renewable generation under its recently listed subsidiary, Enefit Green, which is 77.2% owned. We therefore foresee that its regulated activities--namely networks and its flexible generation, which we perceive to be more stable and predictable--will represent less than 20% of consolidated EBITDA, compared with about 40% previously. This is in part due to the higher prices, but also to the higher share of investment in generation assets, representing a strategic shift. This will weigh negatively on Eesti's business risk, in our view, but we expect regulated earnings will still constitute a meaningful stake of above 20% on average and remain a cornerstone of Eesti Energia's strategy. We also expect EBITDA from networks to remain stable at about €80 million-€95 million annually, and that the company will continue to invest at least €60 million-€70 million annually in regulated assets. This somewhat mitigates the increasing market risk exposure from its expansion into renewable generation. We therefore anticipate the share of regulated earnings in total EBITDA will remain above 20% on average. As a result, we perceive the company's business profile as riskier, and think its future cash flows are more exposed to market conditions and volatility, which has prompted us to increase the threshold for the 'bb' SACP to 25% from 20%. If regulated EBITDA returned to the previous levels of about 40%, we could revise the threshold downward.

Chart 1

As Unregulated Contribution Grows, Regulated Shares Reduce
Eesti Energia's EBITDA split evolution



Source: S&P Global Ratings.

Eesti Energia is focusing on expanding renewable generation capacity through its subsidiary Enefit Green AS. The company seeks to reduce its carbon exposure by investing heavily in low-carbon activities, such as renewable power generation, distribution grid operations, and related network services, such as high-speed internet. Eesti Energia updated its new strategic plan in May 2022. Compared to its previous strategy, the company has put more focus on renewable electricity and reducing the carbon footprint in markets such as Finland and Poland. Its previous strategy included the addition of 600MW of wind and solar parks by 2025, which takes the total installed capacity to 1100MW. The updated strategy includes a 4x increase from the current installed capacity to 1900MW by 2026. We acknowledge that this is a very ambitious strategy and we will monitor the progress as Eesti Energia adds new renewable capacity. We include in our forecast the company's full investment plan. This results in free operating cash flow minus capital expenditure (capex) to debt of about 10% in 2022 and negative 39.10% in 2023-2024. That said, the company has historically over-guided expected spending, and we also note that a fairly large share of the planned capex remains uncommitted.

Eestia Energia's current business mix is still characterized by significant exposure to environmental risks. It is particularly exposed to carbon regulation, since the company operates oil shale-fueled electricity plants and produces shale oil products. In addition, Eesti Energia will also increase its shale oil production, which provides for a less carbon-intensive use of its oil shale reserves compared to power generation, by building a third shale oil plant, Enefit 280-2, which we view as negative. Eesti Energia will remain dependent on generation from shale oil until 2030, since this is when the company has committed to phasing out environmentally unfriendly generation. Eesti Energia's emissions remain higher than many rated peers, at about 374 gram emissions per kilowatt hour (g CO_2/kWh) for its total energy production and 550g CO_2/kWh for electricity production, well above the average for rated European utilities of about 250g CO_2/kWh.

With its new chemical plant, Scope 3 emissions will also increase to about 2.279 million tonnes, which is against the trend for European utilities.

After the IPO in 2021, the group structure is more complex. With the majority of investments in its subsidiary, Enefit Green (77.2% ownership), there is added complexity, and Eesti will have limited access to the cash at Enefit Green. It also introduces subordination risk for Eesti, but we expect the priority debt to remain below 50% in the coming year. We continue to fully consolidate Enefit Green in our analysis, since we expect the proportional deconsolidation effect to have only a minor-to-modest effect, and 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 deconsolidation of Enefit Green. This is because debt will be raised at both Enefit Green and Eesti Energia in the future.

Refinancing risk remains high with the €500 million bond maturing in September 2023. Eesti Energia's only outstanding bond totaling €500 million is maturing in September 2023. The company went to the market well ahead of the maturity of the bond (June 2022) but terminated the transaction based on investor feedback, which was the risk of being in close proximity to Russia. We understand that Eesti Energia is now exploring different options for refinancing, including a sustainability-linked syndicated loan, which we expect will close at the beginning of January 2023. We note that, as of the end of September 2022, Eesti Energia has about €332 million of cash on its balance sheet as well as €320 million of committed credit lines maturing in more than one year, which would partly mitigate upcoming maturities. We still see the refinancing as a risk, so the outlook remains negative.

The group's importance to the Estonian government continues to underpin the rating. We see Eesti Energia as highly important to Estonia (AA-/Stable/A-1+), given the company's crucial role in the electricity and shale-oil markets. Since the beginning of the energy crisis, it has become even more important, since it is by far the largest generator of electricity in Estonia as well as the owner of the electricity distribution network. Since the beginning of the Russia-Ukraine conflict, Estonia has lost about 2.5 terawatt hours (TWh) of imported electricity from Russia, which it has needed to replace. This resulted in Eesti Energia restarting old blocks of its Narva Plant, which mostly burns dirty shale oil, to ensure security of supply for Estonian population.

Our assessment also reflects the €125 million equity injection completed in the second quarter of 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 do not expect to change; and
- 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 the risk of a downgrade if Eesti Energia cannot refinance its only outstanding bond maturing in September 2023. This is because liquidity could come under pressure if it does not refinance the bond on time, which could also prompt a change in the company's investment strategy.

Although we forecast Eesti Energia will post strong credit metrics from 2022-2024 because of strong power price momentum, we expect its credit metrics to return to close to historical levels eventually. We consider FFO to debt of well above 25% and negative discretionary cash flow (DCF) to be commensurate with Eesti Energia's SACP of 'bb'.

Downside scenario

We could lower our ratings if liquidity were to come under pressure or we saw Eesti Energia's operating and financial performance deteriorating without prospects for short-term recovery, with FFO to debt falling sustainably below 25% for a prolonged time.

We could also lower the ratings if:

- The company engaged in large debt-financed investments;
- A further increase of the minority stakes added rating pressure, leading to more pronounced differences between full consolidation and proportional consolidation of Enefit in the credit ratios; or
- Increased political risk depressed Eesti Energia's financial metrics and led to a largely negative DCF-to-debt ratio, for example (although this is not our base case).

Upside scenario

We would revise the outlook back to stable if we saw no pressure on liquidity following the completion of the refinancing.

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 5.2TWh of generation, shale oil production of about 438,000 metric tonnes, electricity distribution with 93% coverage in Estonia, and customer solutions. Reported EBITDA amounted to €317.6 million in 2021. On average, about 35%-40% of EBITDA comes 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. With increasing oil production and higher power price environment, we expect the share of unregulated operations in EBITDA to grow while the contribution from regulated operations should form a relatively smaller part.

Our Base-Case Scenario

Assumptions

- Real GDP to expand by 1.5% in 2022 and 2% in 2023, and 2.6% in 2024. We project that Estonia's real GDP will expand by 1.5% in 2022 compared with our estimate of 3.5% prior to incorporating fallout from the Russia-Ukraine conflict.
- Inflation: Consumer price index growth at a quite high 18.8% in 2022, which we expect to ease to 4.5% in 2023 and 3.0% in 2024.
- Subsidiary Enefit Green to be 100% consolidated, despite the divestment of a minority share of 22.8%.
- Nord Pool electricity price in Estonia at €140-€220/MWh on average in 2022 to 2024.
- Electricity generation:
- --Renewable generation at about 1.1TWh in 2022, 1.5TWh and 2023, and about 3.7TWh in 2025.
- --Thermal generation at about 5.6TWh in 2022 and a peak 7.5TWh in 2023, decreasing toward 2.5TWh because of the closing of old thermal plants.
- Distribution system operator (DSO) activities:
- --Average distribution tariff to remain stable during 2022 to 2024.
- --Stable volume levels over 2022-2026.
- EBITDA margin of 15%-27% during 2022-2026.
- Capex of about €500 million in 2022, about €1,044 million in 2023, and €615 million 2024.
- Dividends amounting to €56 million in 2022, €160 million in 2023, and about €203 million in 2024.

Key metrics

Key metrics -- Eesti Energia AS

	--Fiscal year end Dec. 31 --				
(Mil. €)	**2020a**	**2021a**	**2022e**	**2022f**	**2023f**
EBITDA	204.6	292.9	550-600	550-600	600-650
EBITDA margin (%)	24.5	22.3	20-25	15-20	23-28
Capital expenditure	173.6	217.5	480-520	1020-1060	590-630
Dividends	0	0	50-60	155-165	195-205
Debt to EBITDA (x)	4.3	2.7	1.2-1.4	2.5-2.7	2.5-2.7
Funds from operations to debt (%)	20.6	34.8	70-75	30-35	30-35

*All figures adjusted by S&P Global Ratings. 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 uses by about 1.3x over the 12 months from Sept. 30, 2022. We note that Eesti Energia and Enefit Green have separate financing, implying Eesti Energia cannot freely access cash at Enefit Green, which amounted to €164 million as of Sept. 30, 2022. Eesti Energia has sources over uses (both consolidated and stand-alone) above 1.2x over the next 12 months. However, the debt maturity profile is concentrated, since Eesti Energia has a €500 million bond that matures in September 2023. We understand management is working on a refinancing of the bond but has not been successful to date, partly due to Estonia's geographic position, close to Russia. We understand management now plans to refinance it with a bank syndication, but has so far been unsuccessful.

We view Eesti Energia's relationships with banks is typically sound, but its standing in credit markets is less favorable, as demonstrated by the recent unsuccessful bond refinancing and since the refinancing has taken a fairly long time. That said, we think it should benefit from its position as the largest power producer and from the ownership of the majority DSO operation in Estonia, which is a critical infrastructure with typically very stable cash flows. Following the IPO, there have been important changes in the liquidity set up, since Eesti Energia cannot freely access the cash and credit facilities at Enefit Green. In our analysis, we therefore exclude those sources.

We expect principal liquidity sources over the 12 months from Sept. 30, 2022 will include:

- Cash and cash equivalents of about €332 million;
- Undrawn RCF of €320 million maturing in more than one year; and
- Our forecast of cash FFO of about €480 million.

We expect principal liquidity uses for the same period will include:

- Debt maturities of about €545 million;
- Capex of about €300 million; and
- No dividends.

Environmental, Social, And Governance

ESG credit indicators: E-5, S-2, G-2

Environmental factors are a very negative consideration in our credit rating analysis of Eesti Energia. Eesti Energia's emissions remain higher than many rated peers in Europe, at about 367g CO_2/kWh for its total energy production and 550g CO_2/kWh for electricity production. This ranks Eesti Energia at about the same level as Electricity Supply Board (378g CO_2/kWh) but with higher pollution than CEZ a.s. (330g CO_2/kWh) and Fortum including Uniper (320g CO_2/kWh). That said, the company aims to increase its share of electricity from renewable sources to at least 80% by 2030, and targets carbon neutrality by 2045, which is in line with the Paris Agreement. The company plans to continue using oil shale in thermal power plants, but to phase it out during 2026-2030. We think this places Eesti Energia among the worst performers when it comes to the energy transition.

Issue Ratings - Subordination Risk Analysis

Capital structure

Eesti Energia's policy is to issue all debt at the parent company level. Total outstanding debt stood at €946.6 million as of end-2021. Enefit Green has outstanding debt of €324.1 million, equivalent to about 34% 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	Fair
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Fair
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
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bb
Related government rating	AA-/Stable/A-1+
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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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-