Research Update:

Estonia-Based Eesti Energia Downgraded To 'BBB-' As High Investment Weighs On Metrics

August 27, 2019

Rating Action Overview

- After its debt-funded acquisition of Nelja Energia in 2018, Eesti Energia AS is now investing heavily in renewable and alternative energy.
- We understand that it will use the proceeds from the planned IPO of the minority stake in its renewable subsidiary for growth capex, rather than reducing debt, so the company's funds from operations (FFO) to debt will remain below 25%.
- We are therefore lowering to 'BBB-' from 'BBB' our long-term issuer credit rating on Eesti Energia and our issue rating on its senior unsecured debt.
- The stable outlook indicates that we expect the company to maintain FFO to debt of 20%-25% over 2019-2020, and to continue to benefit from ongoing and extraordinary government support.

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Rating Action Rationale

S&P Global Ratings downgraded Eesti Energia because we no longer expect it to significantly reduce its debt over the next three years. After acquiring green energy provider Nelja Energia in December 2018, Eesti Energia's S&P Global Ratings-adjusted debt increased to €1.098 billion in 2018 from €613 million in 2017, and its FFO to debt fell to about 21% in 2018 from around 38% in 2017. Given Eesti Energia's plan to invest heavily in renewable generation, we expect FFO to debt to remain below 25%, our threshold for a 'BBB' rating.

Previously, we assumed that Eesti Energia was committed to restoring its credit metrics after the acquisition. We anticipated that it might cut its capital expenditure (capex) or use the proceeds from an IPO of a minority stake in its renewable generation segment to pay down debt, so that FFO to debt recovered to above 25%.

We now understand that the IPO has been delayed and will no longer take place in 2019. If and when it materializes, the proceeds will likely be used to fund expansion, rather to repay the debt. Eesti Energia and its controlling shareholder, the government of Estonia, have made a strategic commitment to expanding the share of renewable generation. The heavy investment planned will have environmental benefits and also support long-term competitiveness and security of supply.

Going forward, we expect Eesti Energia's FFO to debt to remain 20%-25%, mainly due to planned investments in renewable generation. We therefore assess its stand-along credit profile at 'bb', compared with 'bb+' previously.

Many of Eesti Energia's legacy assets are relatively expensive to run and environmentally unfriendly, in part because of the fuel they use. As environmental standards tighten, the oil-shale-based power plants on which it depends are becoming less viable. For example, the price of carbon dioxide allowances has risen over the past few years and Eesti Energia now plans to mothball some of its plants due to high emission rates.

We understand that the overall volume of electricity that Eesti Energia expects to generate will fall in future. Closing some of its oil-shale plants will cut its baseload capacity by 600 megawatts (MW). This represents 30% of its total oil-shale-based capacity.

Eesti Energia plans to cover some of the lost capacity by constructing new renewable plants. However, it will have to cover most of the shortfall by purchasing electricity on the wholesale market. This will increase the company's exposure to Nord Pool power prices. Wholesale power markets have been more competitive and prices more volatile since they have become more interconnected across the Nordic and Baltic markets.

We view the acquisition of Nelja Energia as part of Eesti Energia's strategy to increase the proportion generated from renewable and alternative energy sources to 45% of its total generation by 2023. Before the acquisition, Eesti Energia generated only 4% of its energy from green sources such as wind, solar, biomass, and waste. The acquisition boosted this to approximately 15%. It also boosted Eesti Energia's EBITDA by about €45 million per year from 2019. The acquired assets are located mostly in Estonia and Lithuania and benefit from tariffs set on produced renewable energy. In Estonia, the tariff scheme is more favorable than in Lithuania, as Lithuania has fixed subsidies whereas in Estonia the renewable assets receive a fixed premium in addition to the electricity price. The average remaining period of these subsidized tariffs is five years.

Investing further in renewables should help Eesti Energia to retain long-term competitiveness and reduce its exposure to volatile Nord Pool prices, 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 such an investment will make only a limited contribution to EBITDA.

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.

In our view, the regulatory framework continues to provide predictability and support. Moreover, there could be some upside on the distribution tariffs because of an increase in the weighted-average cost of capital (WACC). We understand there are proposals to revise how WACC is calculated. If approved, these could support the company's business risk profile and mean stronger cash flows from electricity distribution. However, our base-case scenario does not include any potential changes to the calculation of WACC.

Outlook

The stable outlook on Eesti Energia stems from our expectation that, over 2019-2020, the company will maintain credit metrics in line with its 'bb' SACP, including FFO to debt of 20%-25%, corresponding to debt to EBITDA of below 4.0x. It also reflects our expectations of ongoing and extraordinary support to the company from its sole owner, the Estonian government.

Downside scenario

We could lower our ratings if we saw Eesti Energia's operating and financial performance deteriorating without prospects for near-term recovery. For example, a tougher market environment and even-lower power prices could cause FFO to debt to fall below 20% and debt to EBITDA to rise above 4.0x. We view the company's ability to contain generation costs as limited.

We could also lower the rating if we considered that Eesti Energia's business risk had weakened permanently. This could result from a structural change in EBITDA generation that would mean a higher share of more volatile power generation and commodity trading business than regulated distribution, or from 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, although we see such a scenario as unlikely currently.

Upside scenario

We could raise the rating if we observed a strengthening of Eesti Energia's credit metrics, so that FFO to debt was above 25%, provided that 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.

Company Description

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

- About 40%-45% from electricity and heat generation and the supply of electricity in Baltic countries;
- About 40% from regulated electricity distribution in Estonia; and
- 5%-10% from shale oil production and other services.

Eesti Energia operates in the electricity and gas markets of the Baltic countries, Poland, Finland, and Sweden. It also operates in the international liquid fuels market. It offers energy solutions that include electricity, heat and fuel production, sales and customer service, and other energy services.

Our Base-Case Scenario

- GDP growth in Estonia at 3% in 2019 and 2.7% in 2020.
- Nord Pool spot electricity prices for Estonia will remain closely aligned with Finnish prices.
- In 2018, the average day-ahead price in Nord Pool Estonia was €47.04 per megawatt hour (/MWh), including a premium of €0.27/MWh to prices in Finland. In the first half of 2019, the average day-ahead price in Nord Pool Estonia was €45.18/MWh. About half of expected selling

volumes for the second half of 2019 are hedged at €43.1/MWh.

- Conservation of old generation units from 2019 will be partially compensated for by additional renewables generation (by Nelja Energia) and expansion of the retail segment. We anticipate electricity generation volumes will reduce by 18% in 2019 and by 7.1% in 2020.
- Conversely, electricity distribution volumes will grow by 2% in 2019, and remain nearly flat going forward. Average distribution tariff to decline to €29.9 per MWh in 2019 from €33.2 per MWh in 2018, based on a recent regulatory decision.
- Average shale oil sales price at about €270-€280 per ton in 2019 and €310 per ton in 2020. Shale oil volumes to be sold in the second half of 2019 are fully hedged at €273.2 per ton
- Additional annual EBITDA of €40 million-€45 million generated by acquired assets.
- EBITDA margin of about 29% in 2019, declining to about 23% in 2020, based on higher share of retail operations.
- Increased annual capex of about €220 million in 2019 and €290 million in 2020, up from €170 million in 2018. We attribute some of the increase to developing renewable projects. Eesti Energia has not committed to these; they are subject to the availability of funding and the success of the IPO.
- Approved dividends of about €57 million in 2019.
- IPO of Eesti Energia's renewable subsidiary in 2020. Proceeds to be used to fund renewable expansion projects.

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

- FFO to debt to remain around 21% in 2019; rising to above 25% in 2020 due to IPO, but falling back to about 22% thereafter.
- Debt to EBITDA to remain 3.3x-3.9x for the next three years.

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 and we don't expect this 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 approval of 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.

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, 2019:

- Cash and cash equivalents of €93 million.
- Full availability under two committed revolving credit facilities totaling €300 million and expiring in July 2020 (€150 million) and June 2021 (€150 million).
- Our forecast of cash FFO of €244 million.

Principal liquidity uses over the same period include:

- Debt repayment of €55.1 million in the subsequent 12 months.
- Capex of up to €258 million, including up to €72 million related to the renewable development projects. However, these development expenditures are not committed and are subject to the availability of funding.
- Dividends of about €44 million.

Covenants

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 if needed.

Environmental, Social, And Governance

Environmental factors are essential to our assessment of Eesti's Energia's business risk, but social and governance factors are currently less critical.

Our assessment of Eesti Energia's business risk remains constrained by its environmentally-unfriendly asset composition and fuel mix. Of Eesti Energia's power plants, 85% by output use oil-shale-based fuel, which is heavily exposed to carbon dioxide emission costs. The company currently receives some carbon dioxide allowances for free.

We understand that Eesti Energia's strategic goal is to produce 45% of electricity from renewable and alternative sources by 2023. Most of Eesti Energia's planned capex will support this strategy, which was the main reason it acquired Nelja Energia in December 2018. The acquisition increased Eesti Energia's green energy generation capability to 15% of the total, from 4%.

In terms of social factors, maintaining a reliable, safe and viable economic network is key to managing regulatory risk and public opinion. In our view, the company has a good track record in this respect. We understand from the company that, as a major employer, it has a social mandate to run some of its oil-shale plants and mines, even though they are environmentally unfriendly.

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, 2019, stood at €1,155 million. After the Nelja acquisition, there is about €242 million of debt at the operating subsidiary, which is 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, even after the acquisition of Nelja Energia.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/--

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: Negative (-1 notch)

Stand-alone credit profile: bb

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

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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
Eesti Energia AS		
Issuer Credit Rating	BBB-/Stable/--	BBB/Negative/--
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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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.