FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Net4gas to 'BB-'; Outlook Evolving

Mon 29 May, 2023 - 02:13 ET

Fitch Ratings - Milan - 29 May 2023: Fitch Ratings has downgraded Net4gas, s.r.o.'s Long-Term Issuer Default Rating (IDR) to 'BB-', from 'BB+', and senior unsecured rating to 'BB-' with a Recovery Rating of 'RR4', from 'BB+'. The Outlook on the IDR is Evolving.

The downgrade reflects our downward revision of Net4gas's transit-related profits in the short-and- medium term. This mainly stems from continuing Russian gas transit towards Ukraine and the Turkish Stream corridor, which limits the transit potential for Net4Gas and is only mitigated by our preliminary expectations of increased regulated revenues.

The Evolving Outlook reflects that rating evolution would depend on the above developments, especially on the regulatory part, compared with our central expectations, while liquidity remains adequate for both 2023-2024.

KEY RATING DRIVERS

Expected Reduction of Alternative Flows: We have materially revised down our expectations of non-Russian gas transited through Net4gas's pipelines to 18 billion-19 billion cubic meters (bcm), including the needs of national demand, from 33bcm forecast in October 2022. This is in light of continuing Russian gas transit through Ukraine and Turkish Stream routes and gas export to Germany from France and Belgium, which directly reduce the gas transit routed through the Czech gas network.

Regulatory Upside: Net4gas's discussion with the Czech regulator to "account for the unprecedented change in the transit flows through the Czech gas transmission system" presents upside opportunities that are difficult to quantify. We see potential for a significant increase of Net4gas's regulatory asset base (RAB) and understand that legal grounds for such an increase exist. However, there is uncertainty over the estimates of the portion of existing infrastructure that would ultimately be included in the RAB. As such, we conservatively factor in only a limited increase in revenue, which is also compatible with our depressed medium-term view of west-to-east alternative flows.

Lower, but Increasingly Regulated EBITDA: Our new projections see materially lower EBITDA over 2024-2026 on average, at slightly more than CZK3 billion, versus the CZK5.5 billion in our October 2022 estimates. On the other hand, our current assumptions imply the share of regulated EBITDA at around 70% (historically around 20%-25%), due to the potential increase of regulated revenues and relatively depressed transit estimates.

Leverage Peak in 2023: We forecast 2023 EBITDA at slightly more than CZK2.2 billion, due to limited transit activity, and free cash flow (FCF) to be potentially eroded by large tax advances to be only reversed in 2024 (treated below FFO). This will lead to double-digit funds from operations (FFO) net leverage in 2023, before it stabilises at around 8.5x in the following three years, mainly on EBITDA normalisation and positive annual pre-dividend FCF estimated at more than CZK1.3 billion.

Upside and Downside to Forecasts: The key downside to our forecasts is represented by only small positive regulatory developments (potentially in the form of RAB increase), which would impair debt capacity at the current rating and require material equity injections to preserve the rating. On the other hand, higher-than-expected recognition of regulated assets and revenues could sustain a higher rating assessment and potential notching up from the IDR for the senior unsecured rating instruments.

A further reduction or even the cessation of Russian gas flow through the Ukrainian and Turkish Stream corridors should benefit Net4gas's gas transit flow, all else being equal. Net4gas may also be entitled to some form of compensation from the filed arbitrations proceedings towards Gazprom, but given the large uncertainty, any development in this respect would represent an upside to our forecast.

Solid Regulatory Framework: Gas transmission in the Czech Republic is fully regulated within a transparent and supportive framework and is in its fifth regulatory period until end-2025. Net4gas's regulatory framework shields the company from any reduction in intra-state transmitted volumes arising from warmer temperatures or a lack of supply, through regulatory compensation is with a two-year time lag.

Furthermore, in the case of a state emergency, transmission system operators (TSOs) are allowed to ask for compensation in the same year directly from the state budget for any intra-state capacity fees lost. This would also smooth cash flow volatility arising from the risk of gas supply curtailments to Czech industrial sectors.

DERIVATION SUMMARY

eustream, a.s. (BBB/Negative; 'bbb-' Standalone Credit Profile (SCP)) is Net4gas's closest rated peer, since both companies own and operate gas transit pipelines in Slovakia and the Czech Republic, respectively. eustream's gas transit displays more resilience as one of the few routes still being used by Russia to Europe (even if at much depressed levels), with regular payments as of now. Furthermore, the SCP differential is explained by the historical low leverage of the Slovakian company (net debt/EBITDA below 2.5x). Positively, Net4gas benefits from a higher share of domestic business with more supportive regulation. For both companies, liquidity is adequate, having implemented a zero dividend policy.

Net4gas is in a weaker competitive position than fully regulated national TSO peers, such as Snam S.p.A. (BBB+/Stable), REN - Redes Energeticas Nacionais, SGPS, S.A. (BBB/Stable) and pure gas distributor, Czech Gas Networks Investments S.a r.l (BBB/Stable). The latter shares the same country, regulator and a supportive fifth regulatory period as Net4gas, but its almost fully regulated earnings allow for a higher debt capacity than ship-or-pay contracts, especially if the latter are short-term in nature.

KEY ASSUMPTIONS

-Alternative transit gas flows run on short-term bookings up to 10 bcm in the medium term (on top of domestic consumption)

- TSO revenues based on the current regulatory framework, plus upsides related to additional asset recognition into RAB from 2024

- Annual operating expenditure of CZK1.2 billion, assuming some cost rationalisation

-Potential cash tax advance payment in 2023 to fully reverse in 2024

- No working capital absorption to 2026

- Cumulative capex of CZK3.7 billion in 2023-2026 (in a decreasing trend), assuming some spending rationalisation

- No dividend payments from 2022 onwards

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- Evidence of materially improved international gas transit prospects or materially better-than-expected positive regulatory developments

-FFO net leverage below 7.7x, with a business mix comprising about 70% of EBITDA from regulated activities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

-No materially positive regulatory updates for the domestic gas transport business amid continuously weak alternative gas transit and absent significant shareholder support

-FFO net leverage above 8.5x, with a business mix comprising about 70% of EBITDA from regulated activities

-Reinstatement of dividend distribution

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Cash on balance sheet was around CZK6.8 billion at end-2022, which was sufficient to cover 2023 and 2024 operating expenses (of about CZK1.2 billion a year), financial charges (about CZK1.5 billion a year) and expected capex (cumulatively about CZK2.1 billion), even with the sole support of the current TSO business (about CZK2.2 billion in revenues a year). We expect the first significant debt maturity only from mid-2025 at almost CZK10 billion.

ISSUER PROFILE

Net4gas is the Czech public national gas TSO, and a relevant infrastructure for gas transit to central European markets. With a large bi-directional flow capacity, Net4gas operates a large-scale high-pressure gas transmission and transit system of 3,973 km of pipelines.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
NET4GAS, s.r.o.	LT IDR	BB- Rating Outlook Evolving	Downgrade		BB+ Rating Outlook Negative
senior unsecured	LT	BB-	Downgrade	RR4	BB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 03 Mar 2023)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 12 May 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

NET4GAS, s.r.o.	EU Issued, UK Endorsed

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