Research Update:

Gas Distributor Czech Gas Networks Investments Affirmed At 'BBB+' On Majority Stake Sale To CEZ; Outlook Stable

March 27, 2024

PRIMARY CREDIT ANALYST

Emeline Vinot
Paris
+ 33 014 075 2569
emeline.vinot@spglobal.com

SECONDARY CONTACT

Massimo Schiavo
Paris
+ 33 14 420 6718
Massimo.Schiavo@spglobal.com

Rating Action Overview

- On March 21, 2024, integrated Czech utility CEZ announced its intention to acquire Macquarie's ownership in Czech Gas Networks Investments (CGNI) (55.21%) for a total consideration of €850 million, a transaction we expect to close over the next few months.
- We do not expect the acquisition to impact CGNI's financial policy, and in our view the company will continue to generate stable and predictable cash flows from its regulated gas operations under the current 2021-2025 regulatory period in a framework we view as very supportive, with adjusted funds from operations (FFO) to debt on average of 13%-14% over 2024-2025.
- We expect CGNI to be moderately important to CEZ's long-term strategy and EBITDA because it will generate about 10% of CEZ's EBITDA in 2026, with CGNI's EBITDA expected to average about Czech koruna (CZK) 10.5 billion (about €400 million) over 2024-2025.
- We therefore affirmed our rating on CGNI at 'BBB+'.
- The stable outlook reflects that on CEZ and our expectation that CGNI will continue to operate steadily until the end of the current regulatory period with expected adjusted FFO to debt well above the 9% threshold for the current rating, and with no change in the company's financial policy after the change of the majority shareholder.

Rating Action Rationale

We view CGNI as moderately strategic for CEZ (A-/Stable/--). In our view, the acquisition of 55.21% of CGNI for a total consideration of €850 million shows the continuous relevance of gas distribution assets in Czech Republic. Indeed, we expect that gas will continue to play strategic role in coal replacement in Czechia in both the heat and power sector as well as in stabilizing the electricity grid. It is our expectation that the integration of CGNI enables CEZ to reach about 30% of regulated activities by 2026 from about 20% in 2023, in a declining power price environment.

We therefore see CGNI as a moderately strategic part of the CEZ group. While we assume that the change of ownership will not trigger any change in CGNI's financial policy, we could revise the assessment if we see a track record of supportiveness of CEZ toward CGNI that could be seen through a positive change in the financial policy or less upstreaming of dividends, interest, and amortization on the shareholder loan.

The main rating constraint for CGNI remains its aggressive dividend policy, even though we view the shareholder commitment to the rating as supportive. We expect CGNI's free operating cash flow to remain positive at about CZK4 billion-CZK5 billion over 2024-2025, due to strong cash flow generation and relatively low capital expenditure (capex) compared with peers. As CGNI's financial policy is to distribute all reasonably available cash to shareholders, we expect this will result in volatile discretionary cash flow of negative CZK1.5 billion to positive CZK 1.5 billion over 2024-2025, given that shareholder remuneration will be about CZK3 billion-CZK5 billion annually. At the same time, management targets maintaining a strong investment-grade rating. FFO to debt is expected to remain strong around 13%-14% on average over 2023-2025, well above our downside threshold of 9%. The dip in FFO to debt to 10.4% in 2023 was largely due to the K-factor adjustment in revenue due to difference between planned and actual volumes and costs and will be recovered as early as 2024, as per the regulatory formula. We will monitor whether the new ownership structure will result in a change in financial policy.

The supportive Czech framework provides full coverage of costs and protection against volume and commodity risk. We see the Czech Republic's regulatory framework for gas networks as supportive because it is transparent, stable, and predictable. The framework is currently in its fifth regulatory period (2021-2025) and is supervised by an independent regulator: the Energy Regulatory Office. The framework uses a revenue-cap system based on the regulated asset base, whereby the maximum allowed revenue is linked to cost and profit allowances. The nominal, pre-tax weighted average cost of capital (WACC) is set for the whole regulatory period, except when the income tax rate of legal entities changes. From 2024, the pre-tax WACC is set at 6.52% in comparison to 6.43% previously to reflect the change of the income tax rate to 21% from 19%. The delta between the two WACCs will be reflected from 2025 through the K-factor. CGNI is exposed to very limited volume fluctuation because 40% of revenue is collected through fixed charges. In addition, the regulatory formula includes a corrective mechanism that adjusts revenue, ensuring that CGNI collects all revenue allowed but not collected at the time (for example, due to lower consumption or a mild winter) and vice-versa returns all real revenue collected in excess of allowed revenue at the time (for example, due to higher consumption or a cold winter). However, this is settled with a two-year delay, which can cause some profit and loss and cash flow volatility. We will monitor the evolution of the regulatory framework parameters and methodology when the sixth period (2026-2030) begins, and its impact on CGNI.

Outlook

Our stable outlook incorporates our view that CGNI will continue generating stable cash flows from its regulated gas operations and maintain FFO to debt on average of 13%-14%, well above the 9% downside threshold for the current rating.

Downside scenario

We see the likelihood of a downgrade as remote because it would occur if we were to downgrade

CEZ by two notches to 'BBB' or if we were to revise down our view of CGNI's stand-alone credit profile (SACP) by two notches to 'bbb-', neither of which we expect.

We would consider revising down the SACP by one notch to 'bbb' if we believed that CGNI's FFO to debt would move below 9%, or if its debt to EBITDA stayed above 7.0x, which could occur because of:

- Weaker operating performance or reduced profitability, from, for example, cost overruns compared with the regulatory assumptions or a very harsh set of assumptions in the next regulatory period, which we do not foresee.
- A more aggressive shareholder policy.

This would not, however, trigger a downgrade to 'BBB' on a stand-alone basis.

Upside scenario

An upgrade to 'A-' could occur if:

- We upgraded CEZ;
- CGNI displayed a supportive financial policy implying a commitment to maintain FFO to debt of at least 14% sustainably; or
- If we observed a continuously supportive regulatory framework for the 2026-2030 period, which we would view in line with other frameworks we currently assess as strong.

Company Description

CGNI has two operating subsidiaries, GasNet (representing 90% of revenue) and Grid Services (10%). GasNet is the country's largest gas distribution system operator, with a market share of about 80%. It owns and operates about 65,000 kilometers of distribution networks, effectively distributing about 70 terawatt hours of gas per year to more than 2.3 million customers. Grid Services provides maintenance, development, metering, and dispatch for GasNet's distribution infrastructure.

Currently, CGNI is 55.21% directly owned by Macquarie Infrastructure and Real Assets (MIRA). Once the ongoing transaction is closed, MIRA's shareholding will be transferred to CEZ. The other two shareholders BCI and Allianz keep their respective shares of 26.29% and 18.5%.

Our Base-Case Scenario

Assumptions

- GDP growth in the Czech Republic of 2.0% in 2024, and 2.5% in 2025.
- Consumer Price Index growth of 2.8% in 2024, and 2.3% in 2025 in Czech Republic.
- High predictability of earnings from CGNI's gas distribution activities for the current regulatory period, with a WACC of 6.52% adjusted for the change in tax rate to 21% from 19%.
- EBITDA margin of 58%-60% over 2024-2025.

- Average cost of debt of 2.7%-3.3% over 2024-2025.
- Dividend payout ratio of about 100%, although this is flexible to maintain the rating and liquidity.
- Our treatment of shareholder loans as equity and the interest paid on it as dividends.
- Annual capex of about CZK5.3 billion over 2023-2025.
- No acquisitions

Key metrics

Czech Gas Networks Investments S.a.r.l.--Key metrics*

	--Fiscal year ended Dec. 31--				
Mil. CZK	**2021a**	**2022a**	**2023e**	**2024f**	**2025f**
EBITDA	10,487	9,470	7,500-8,000	10,500-11,000	10,500-11,000
EBITDA margin (%)	69.6	67.7	60-65	55-60	55-60
Funds from operations (FFO)	8,387	7,236	5,500-6,000	8,500-9,000	8,500-9,000
Capital expenditure	4,520	3,736	4,500-5,000	5,000-5,500	5,500-6,000
Free operating cash flow (FOCF)	2,652	3,396	2000-2,500	4,500-5,500	4,000-4,500
Shareholder remuneration	8,773	2,739	3,000-3,500	3,000-3,500	5,000-5,500
Discretionary Cash Flow (DCF)	(6,121)	657	(1,500)-(1,000)	1,000-1,500	(1,500)-(1,000)
Debt	56,168	53,164	50,000-55,000	50,000-55,000	50,000-55,000
FFO to debt (%)	14.9	13.6	10.0-10.5	16.5-17.0	15.5-16.0
DCF to debt (%)	(10.9)	1.2	(2.5)-(2.0)	2.5-3.0	(2.5)-(2.0)

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess CGNI's liquidity as adequate because we expect liquidity sources will exceed uses by about 1.3x over the next 12-24 months starting Jan. 1, 2024, even if EBITDA declined by 15%. The company has no debt due until 2026.

Principal liquidity sources:

- CZK1.2 billion available cash.
- FFO of about CZK9 billion-CZK10 billion.
- CZK1.5 billion undrawn committed facilities due May 2028.

Principal liquidity uses:

- About CZK5 billion-CZK6 billion capex.
- Roughly CZK3 billion-CZK4 billion shareholder distributions, including interest on the shareholder loan.
- No debt maturity before 2026.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/--
Business risk:	Excellent
Country risk	Intermediate
Industry risk	Very Low
Competitive position	Strong
Financial risk:	Significant
Cash flow/leverage	Significant (Low Volatility Table)
Anchor	a-
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Negative (-1)
Stand-alone credit profile:	bbb+
Group credit profile	a-
Entity status within group	Moderately Strategic (no impact)

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- 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: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Czech Energy Company CEZ 'A-' Ratings Affirmed On The Announced Acquisition Of A Majority Stake In CGNI; Outlook Stable, Mar 22, 2024
- Eastern Europe: Higher Yields Will Weaken Credit Metrics And Liquidity, Jan. 8, 2024

Ratings List

Ratings Affirmed	
Czech Gas Networks Investments S.a r.l.	
Issuer Credit Rating	BBB+/Stable/--
Senior Unsecured	BBB+