FitchRatings

RATING ACTION COMMENTARY

Fitch Places NET4GAS on Positive Watch on Announced Acquisition by CEPS

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Fitch Ratings - Milan - 04 Oct 2023: Fitch Ratings has placed NET4GAS, S.r.o.'s (NET4GAS) Long-Term Issuer Default Rating (IDR) and senior unsecured ratings of 'BB-' on Rating Watch Positive (RWP). The IDR was previously on Evolving Outlook. A full list of rating actions is below.

The RWP follows CEPS, a.s. signing of an agreement to acquire full ownership of NET4GAS at limited equity value, while fully assuming NET4GAS's net financial obligations. The RWP reflects our expectation that the acquisition by a considerably stronger group will benefit NET4GAS's ratings due to Parent Subsidiary Linkages, with an upgrade of at least one notch.

Fitch will resolve the Positive Watch once the transaction has been completed, which could take more than six months.

KEY RATING DRIVERS

Acquisition by a Stronger GRE: Fitch expects the stronger credit profile of the fully state-owned CEPS to have a positive influence on NET4GAS's ratings, should the acquisition materialise as expected. We have no information on the legal incentives of CEPS to support NET4GAS, such as a cross default provision that could lead to an equalisation of NET4GAS's rating with the consolidated profile of CEPS. On a preliminary basis, we see limited operational synergies between the companies, but a moderate strategic relevance of NET4GAS within the CEPS group, due to the importance of its gas transmission assets for energy security in the Czech Republic.

CEPS Consolidating Key Energy Infrastructures: The Czech Republic (AA-/Negative), through CEPS, has recently extended its direct influence over critical energy infrastructures, significantly strengthening national energy security and independence. The NET4GAS acquisition will significantly diversify CEPS's business profile form its historical electricity transmission operator role. Its activities will then span from gas storage business, including tanks, to regulated gas transportation and international gas transit activity.

Key Tariff Decision Ahead: NET4GAS's Standalone Credit Profile (SCP) remains mainly reliant on the regulator's approach towards the gas transport tariff system, given depressed west-to-east alternative gas flows since the Ukraine war. We believe the regulator may allow a material increase of NET4GAS's regulatory asset base (RAB). The regulator's decision on 2024 final tariffs for transmission system operators (TSOs), expected to be published by end-November, could provide material hints about the regulator's approach for the medium term.

Weak 2023 EBITDA: We project EBITDA at slightly below CZK2 billion in 2023 (2022: CZK11.3 billion), due to limited transit activity, and free cash flow (FCF) drain at slightly higher than CZK 1 billion. This results in a double-digit funds from operations (FFO) net leverage in 2023, before it stabilises at around 8.0x over the next three years, as EBITDA normalises at slightly more than CZK3 billion and with positive annual FCF estimated at more than CZK1.3 billion (we assume no dividends). We continue to forecast a share of regulated EBITDA at around 70% (historically around 20%-25%), on an increase of regulated revenues and fairly depressed transit revenues.

Risks to SCP Forecasts: The key downside to our forecasts is represented by only small positive regulatory developments (such as a very limited RAB increase), which would impair debt capacity at the current rating. On the other hand, higher-than-expected recognition of regulated assets and revenues could sustain a higher rating and notching uplift from the IDR for the senior unsecured debt ratings.

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 compensation from its filed arbitrations proceedings against Gazprom, but their considerable uncertainty means developments in this respect would represent an upside to our forecast.

Solid Regulatory Framework: Gas transmission in the Czech Republic is fully regulated under a transparent and supportive framework and is in its fifth regulatory period until end-2025. It shields NET4GAS from a reduction in intra-state transmitted volumes arising from warmer temperatures or a lack of supply, through regulatory compensation, albeit with a two-year time lag. Further, TSOs in a state emergency can 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-' SCP) is NET4GAS's closest rated peer, as 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. In addition, the SCP differential is explained by the historically 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, given their 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.

KEY ASSUMPTIONS

Key Assumptions Within Our Rating Case for the Issuer:

-Alternative transit gas flows run on short-term bookings of up to 10 billion cubic meters 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, including some cost rationalisation

-Negligible working-capital absorption to 2026

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

-No dividend payments

RATING SENSITIVITIES

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

- Completion of the acquisition, coupled with our assessment of available support from CEPS under our Parent and Subsidiary Linkage Rating Criteria

- Materially improved international gas transit volumes or better-than-expected positive regulatory developments

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

Factors That Could, Individually or Collectively, Lead to a Negative Rating Action/Downgrade (if the Acquisition is not Completed):

-No materially positive regulatory updates for the domestic gas transport business amid continuously weak alternative gas transit

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

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Cash on balance sheet was around CZK5.7 billion at end-August 2023. This is sufficient to cover remaining 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 if the TSO business were the sole source of revenue (about CZK2.2 billion 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 provides the 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 4,058 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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
NET4GAS, s.r.o.	LT IDR	BB- Rating Watch Positive	Rating Watch On		BB- Rating Outlook Evolving
senior unsecured	LT	BB- Rating Watch Positive	Rating Watch On	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)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Climate Vulnerability in Corporate Ratings Criteria (pub. 21 Jul 2023) (including rating assumption sensitivity)

Exposure Draft: Government-Related Entities Rating Criteria (pub. 15 Sep 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

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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

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