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Research Update:

Lithuanian State-Owned Utility Ignitis Group 'BBB+' Ratings Affirmed; Outlook Remains Negative

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Rating Action Overview

- We believe Ignitis Group--Lithuania's largest multi-utility, which generated €206.8 million of EBITDA in 2019--might underperform for a third straight year, with funds from operations (FFO) to debt below our 23% rating threshold.
- However, the Lithuanian government, Ignitis Group's owner, announced in February its recommendation to sell up to a 33% stake in the company, with plans to use some of the proceeds to decrease the group's leverage and expand renewables generation.
- Moreover, we anticipate that lower capital expenditure (capex) after major projects are finalized, divestment of non-core assets, EBITDA growth, or working capital inflow from EPSO-G could lead to a recovery of credit metrics in 2020.
- We are therefore affirming our 'BBB+' ratings on Ignitis Group and its senior unsecured debt.
- The negative outlook indicates the possibility of a downgrade over the next year if there is no recovery in credit metrics, in particular if FFO to debt does not increase beyond 23% by the end of 2020.

Rating Action Rationale

We anticipate that Ignitis Group's credit metrics will recover by the end of 2020 on the back of various protective measures. In 2018-2019, Ignitis Group's financial metrics were under pressure due to high electricity purchase price, lower generated volumes, and large capex. Last year, Ignitis group posted S&P Global Ratings-adjusted FFO to debt of about 19%, which was in line with our expectations but below our rating threshold of 23%, and debt to EBITDA was 4.8x. We affirmed our ratings because, under our current base case, we expect the group's credit metrics to recover from 2020. Our assessment factors in the company's commitment to achieving FFO to debt of about 23%, which we view as commensurate with its current credit quality. We also expect ongoing and extraordinary support to the company from the Lithuanian government. The recovery of credit metrics could stem from the following factors:

- Large investments are close to completion. We expect capex to remain high in 2020 at around

€425 million, as the construction of two waste- and biomass-fired plants-- Vilnius CHP Plant (VKJ) and Kaunas CHP Plant (KKJ)--are finalized and modernization of the distribution system network is finished. We expect capex to decline to €320 million in 2022 and be at €150 million-€200 million annually thereafter.

- After commissioning of VKJ, expected at the latest in the first quarter of 2021, the group is obliged to sell 49% of the plant, as agreed with European Commission, within 180 days. The investment in this project totaled €344 million. We understand the project has been delayed by two to three months due to unforeseen circumstances. Although execution risks remain, it is now on track for completion in first quarter 2021. We currently assume the sale will proceed according to plan, and we believe that if the disposal is delayed due to the COVID-19 pandemic, the company will likely get an extension and not have to repay the grant.
- Repayment of EPSO-G receivables. In 2012, an unbundling process led to Ignitis Group selling shares in its electricity transmission grid company Litgrid to EPSO-G, which is owned by the Ministry of Energy. Ignitis Group was to receive the proceeds during 2017-2020. We understand outstanding receivables amount to about €149 million and that the government intends for EPSO-G to pay this amount in full in 2020. We do not include full repayment in our base case however, since we understand there might be delay due to COVID-19 if EPSO-G faces difficulties in raising debt to pay this receivable.

If one or a combination of the above factors materialize in 2020, we forecast a rapid recovery in credit metrics, notably with FFO to debt staying above our 23% rating threshold. Conversely, if we see delays in completing VKJ, executing the partial IPO, or receiving working capital inflow from EPSO-G, we believe Ignitis Group's credit metrics are unlikely to recover to levels consistent with a 'bbb' stand-alone credit profile (SACP).

The recently announced IPO could lead to a substantial recovery in credit metrics in 2020 if it happens. On Feb. 28, 2020, the working group set up by Lithuania's Ministry of Finance recommended an IPO of Ignitis Group. The intention is to sell 25%-33% of Ignitis Group, while the government remains the majority shareholder. We understand the recommendation is for an IPO in September, but we cannot rule out a delay due to the current market volatility caused by the COVID-19 pandemic. The government proceeds from the IPO would go toward reducing leveraging at Ignitis Group, and strengthen the country's energy independence by expanding its renewables generation capacity. Even though we believe the government is committed to the IPO, we do not include the potential proceeds in our base case because of uncertainty regarding whether the transaction will take place, and when. If the IPO materializes, we expect Ignitis Group's FFO to debt to remain above our 23% threshold, with substantial headroom.

A supportive and predictable regulatory framework and the group's importance to the Lithuanian government support the rating. A supportive and predictable regulatory framework remains the key credit factor supporting our assessment of Ignitis Group's satisfactory business risk profile. The current five-year regulatory period ends in 2021 for electricity distribution, which accounts for 73% of the group's regulated asset base (RAB) and in 2023 for gas distribution (10% of the RAB). Although the bulk of the company's assets and growth opportunities are within its electricity distribution network, the tariffs for gas distribution, public supply, and regulated generation are also transparent and based on the traditional RAB model, incorporating principles of long-run average incremental cost for distribution networks. Only guaranteed supply is based on the market price plus 25%. We see Ignitis Group's unregulated generation and supply business (about 20% of EBITDA) as diluting its credit profile. This is because of its inherent exposure to power prices, demand risk, and--to some extent--hydrology risk. That said, we understand that wind farms benefit from long-term feed-in tariffs, which support cash flow visibility and stability. We continue to view Ignitis Group as a government-related entity (GRE), and see a moderately high likelihood that Lithuania would provide timely and sufficient extraordinary support to the group in the event of financial distress. This provides a one-notch uplift to the 'bbb' SACP.

Outlook

The negative outlook indicates that we could lower the ratings during the next year if the current deterioration in Ignitis Group's financial metrics does not reverse, and FFO to debt stays below 23% with no visible prospects of recovery. For the current rating, we expect that the regulatory and operating environment will remain supportive and the majority of cash flows will come mainly from low-risk distribution business and supportive financial policy. We also assume that the company's liquidity will remain adequate. We exclude potential IPO proceeds from our base case.

Downside scenario

We could lower the ratings if Ignitis Group's financial and operating performance materially deviates from our base case, leading us to revise down our assessment of its SACP.

This could result from:

- Weaker and more volatile cash flows, such that FFO to debt deteriorates significantly below 23% and does not recover by the end of 2020;
- Inability to sell 49% of VKJ in 2021;
- A large debt-financed acquisition while the large investment program is still underway; or
- Pressure on liquidity, which is not our base case.

We could also lower the rating if we see a reduced likelihood of Ignitis Group receiving extraordinary support from the Lithuanian government, which we currently do not expect. In addition, we could consider a downgrade if there is no working capital inflow related to receivables from EPSO-G this year as anticipated.

Upside scenario

We would revise our outlook to stable if we believe the company's credit metrics are set to recover, notably with FFO to debt higher than 23%, which could happen in the event of stronger EBITDA generation, capex savings, lower leverage, or the prompt collection of the EPSO-G receivable and execution of the IPO in 2020.

Company Description

Ignitis Group UAB is one of the largest energy companies in Lithuania, operating electricity and gas distribution and electricity generation and supply businesses. The group generated revenue of €1.09 billion in 2019 under International Financial Reporting Standards (IFRS). In 2019, the company distributed 9.6 terrawatt hours of electricity to 1.6 million customers across Lithuania. Ignitis Group is a natural monopoly in Lithuania and is not subject to competitive pressures.

The Lithuanian government, represented by the Lithuanian Ministry of Finance, currently owns

100% of the group.

Our Base-Case Scenario

Assumptions

- Overall revenue decline of only 3.2%, due to lower prices in the Nord Pool zone and reduced electricity consumption due to the effects of the COVID-19 pandemic.
- A stable weighted average cost of capital (WACC) for the electricity segment of about 5.3% in 2020-2021. WACC for gas segment increased to 3.8% from 3.6% in 2019 and is expected to be stable.
- Power prices of about €30 per megawatt hour (/MWh) in the Baltic region in 2020, and increasing to €40/MWh-€45/MWh during 2021-2023.
- Capex of around €420 million in 2020 and €320 million in 2021, higher than the historical average mainly due to construction work on KKJ and VKJ and higher investments in the distribution system network.
- Partial repayment of EPSO-G receivables of at least €49 million in 2020.
- Lower dividend payout in 2020 of €80 million, owing to the partial distribution of proceeds from EPSO-G.
- Temporary regulatory differences in EBITDA; historically, these were returned to customers in subsequent years.
- The divestment of noncore assets for around €50 million.
- Sale of up to 49% of VKJ 180 days after its commissioning, which is scheduled for fourth-quarter 2020.

Key metrics

Ignitis Group Key Metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2018a**	**2019a**	**2020e**	**2021f**	**2022f**
EBITDA	145.5	205.2	250-270	290-310	290-310
Capital expenditure	415.4	427.5	420-430	230-240	200-210
Debt§	762.2	994.8	1,100-1,200	1,000-1,100	1,000-1,100
Debt to EBITDA (x)	5.2	4.8	4.2-4.4	3.4-3.6	3.5-3.7
FFO to debt (%)	16.8	18.7	20-21	25-27	24-26

*All figures adjusted by S&P Global Ratings. §2019 year-end debt consists of net financial debt of €x mil. with key adjustments being €y mil. in leases, €z mil. in pension. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess the company's liquidity as adequate, with the ratio of liquidity sources to liquidity uses at 1.2x. Supportive qualitative factors include strong bank support, the company's standing in credit markets, ongoing benefit of its state ownership, and the expectation of near-term financing plans to offset substantial capital spending plans. On this basis, we expect annual cash flow generation, the group's cash flow position, and committed credit facilities will cover expected cash outlays (mainly capex and debt maturities) by more than 1.2x over the 12 months from March 31, 2020.

Ignitis Group's principal liquidity sources for the 12 months from March 31, 2020, are:

- €113 million of unrestricted cash and cash equivalents;
- €174 million of undrawn committed bank lines maturing in May 2020;
- €254 million of cash FFO; and
- €54 million of government grants to be received.

Principal liquidity uses for the same period comprise:

- €88.9 million of debt maturities;
- €30 of working capital outflow due to COVID-19;
- €250 million of maintenance and committed capex; and
- €70 million of dividends.

Covenants

The company has a loan agreement with the European Investment Bank that includes a number of covenants, including Ignitis Group maintaining an investment-grade rating.

Issue Ratings--Subordination Risk Analysis

Capital structure

Ignitis Group's capital structure comprises €600 million of senior unsecured debt issued at the parent level, together with unrated debt of €279 million and €187 million issued by subsidiaries.

Analytical conclusions

We rate the group's debt 'BBB+', the same level as the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer credit rating: BBB+/Negative/--

Business risk: Satisfactory

- Country risk: Intermediate risk
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Sovereign rating: A+/Stable/A-1
- Likelihood of government support: Moderately high (+1 notch)

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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Ignitis Group UAB	
Issuer Credit Rating	BBB+/Negative/--
Senior Unsecured	BBB+