

Research Update:

# AB Ignitis Group Outlook Revised To Stable From Negative On Successful IPO; 'BBB+' Ratings Affirmed

November 12, 2020

## Rating Action Overview

- On Oct. 2, 2020, Ignitis Group--Lithuania's largest multi-utility--successfully raised €450 million selling 28% of its equity to the market through IPO.
- We understand that uses of the proceeds will include reducing leverage and expanding renewable generation capacity, among others. This should improve credit metrics, notably funds from operations (FFO) to debt above 23%, by the end of 2020.
- Moreover, although the Lithuanian government's stake in Ignitis has reduced to 72% from 100%, we continue to assume that Ignitis will maintain its important role as the country's largest power company.
- As a result, we are revising our outlook on Ignitis to stable from negative and affirming our 'BBB+' issuer credit rating on the group. We are also affirming our 'BBB+' issue rating on its senior unsecured debt.
- The stable outlook reflects our view that Ignitis' credit measures will recover by the end of 2020 and FFO to debt will remain above 23%.

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## Rating Action Rationale

**The successful IPO will rapidly restore credit metrics by the end of 2020 to support the current rating level.** Ignitis raised €450 million through its IPO on the London and Vilnius stock exchanges on Oct. 20, 2020, by issuing 26.82% of new shares. We understand that the proceeds will go partially toward reducing leverage at Ignitis, general corporate purposes, but mainly to strengthen the country's energy independence by expanding its renewables generation capacity and investing in its network segment. We now expect rapid recovery in credit metrics, notably FFO to debt reaching and staying well above 23% over 2020-2022, from around 19% (our threshold for a 'BBB+' rating) in 2019. Nevertheless, we expect largely negative discretionary cash flows (DCFs; operating cash flows after capital expenditure [capex] and dividends)--of around negative €180

million to negative €250 million during 2020-2022. This is due to ongoing investment in modernizing the distribution system operator (DSO) network and constructing wind and solar power plants in the Baltics and Poland.

We note that U.K.-based institutional investors account for approximately one third of overall demand for Ignitis shares, with the remainder originating mostly from the Baltics, the Nordics, and Continental Europe. The European Bank for Reconstruction and Development acquired €67.5 million worth of shares to become Ignitis' largest minority shareholder. Lithuania's Ministry of Finance continues to be the company's majority shareholder with a stake of 73.08%.

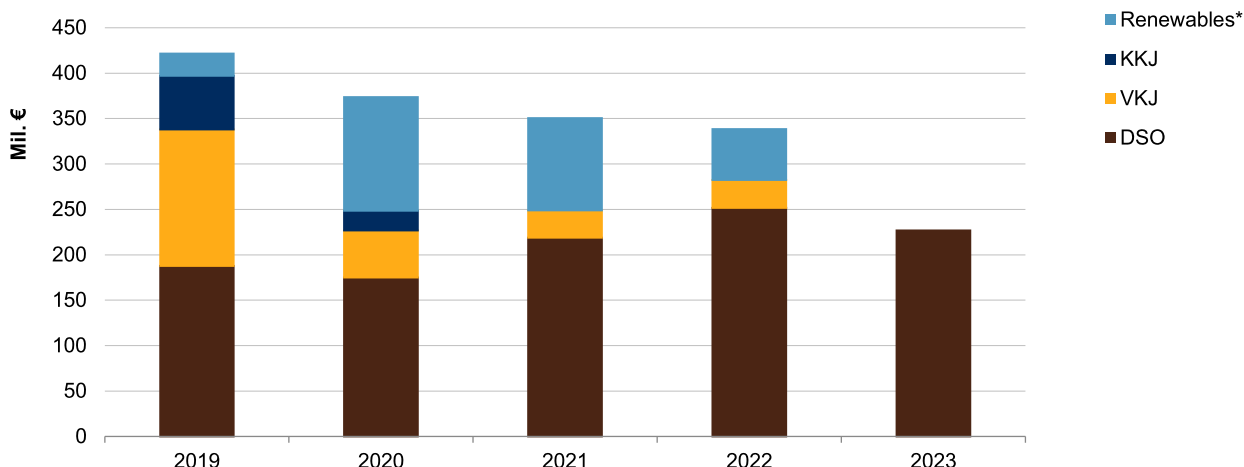
**We expect the current headroom in credit metrics to shrink as Ignitis is committed to expanding its renewable generation.** Ignitis will likely use a large part of the IPO proceeds to fund its large capex program. Therefore, even though we currently forecast FFO to debt of above 30% initially after the IPO, we expect negative free operating cash flow and the existing headroom in credit metrics to reduce.

We expect capex to remain at €360 million-€400 million over 2020-2022, during which time the group will invest around 40%-50% toward modernizing its DSO network. The remaining capex will be mainly for renewable expansion and maintenance of the current power plants, which should boost the country's energy independence.

We note that Lithuania currently imports around two thirds of electricity to meet the country's demand, which is the proportion of any country in Europe. Lithuania's National Energy Independence Strategy therefore states that by 2030, it will see domestic wind power plants produce 50 per cent of the country's electricity. In the updated long-term corporate strategy presented in June 2020, we understand that Ignitis is aiming to achieve 4 gigawatts (GW) of installed green generation capacity by 2030 from the current 1.1GW. The group is heavily investing in renewable generation in the Baltics and Poland.

Chart 1

### Ignitis Group's Capital Expenditure Breakdown



Source: S&P Global Ratings. \*Includes secured projects only.  
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In September 2020, Ignitis formed a partnership with renewable energy leader Ocean Winds--created by Engie and EDPR--to develop offshore wind farm projects, mainly in Lithuania but also in the U.K. This partnership could bring foreign investment of more than €700 million to the Lithuanian offshore wind energy sector. We understand that total capex is around €1.5 billion-€2.0 billion and comprises two projects:

- The Moray West Offshore Wind Farm Project in the U.K., in which Ignitis would buy a 5% stake; and
- An offshore wind farm in Lithuania, where Ignitis would hold a 51% stake.

Ignitis' total investment would be around €750 million-€1 billion starting from 2023. We do not include these projects in the forecast mainly due to the uncertainties Ignitis is still facing. The final investment decision will depend on the result of the auction scheduled for 2023. We will however monitor the progress of this partnership.

**Sound regulatory oversight and the group's importance to the Lithuanian government support**

**the rating.** A supportive and predictable regulatory framework remains the key credit factor underpinning our assessment of Ignitis' satisfactory business risk profile. The current five-year regulatory period ends in 2021 for electricity distribution, which accounts for 76% of the group's regulated asset base (RAB), and in 2023 for gas distribution (12% of the RAB). Although the bulk of Ignitis' 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. This incorporates the principles of long-run average incremental cost for distribution networks. Only guaranteed supply is based on the market price plus 25%. We see Ignitis' 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 as a government-related entity, and see a moderately high likelihood that the Lithuanian state would provide timely and sufficient extraordinary support to the group in the event of financial distress, even after IPO, as the government remains a majority shareholder of the group. We therefore apply a one-notch uplift to the 'bbb' stand-alone credit profile on Ignitis to derive the 'BBB+' issuer credit rating.

## **Outlook**

The stable outlook on Ignitis reflects our expectation that the operating and regulatory environment will remain supportive over the next two years, mainly from what we see as its relatively low-risk regulated distribution business. We further anticipate that Ignitis' credit measures will recover by the end of 2020 and stay in line with the ratings, including FFO to debt of at least 23%.

## **Downside scenario**

We could lower the ratings if Ignitis' financial and operating performance materially deviates from our base case, leading us to revise downward our assessment of its SACP. This may result from:

- Weaker and more volatile cash flows, such that FFO to debt deteriorates significantly below 23% without any prospects for recovery;

- A large debt-financed acquisition while the large investment program is still underway;
- Materially higher investments than our base case; or
- Pressure on liquidity, which is not our base case.

We could also lower the rating if we see a reduced likelihood of Ignitis receiving extraordinary support from the Lithuanian government, which we currently do not expect.

## **Upside scenario**

We see rating upside as remote mainly due to company's heavy investment program. However, we could raise the ratings on Ignitis if we revise upward the SACP to 'bbb+', if the group achieved FFO to debt sustainably above 30% with neutral to slightly negative discretionary cash flow.

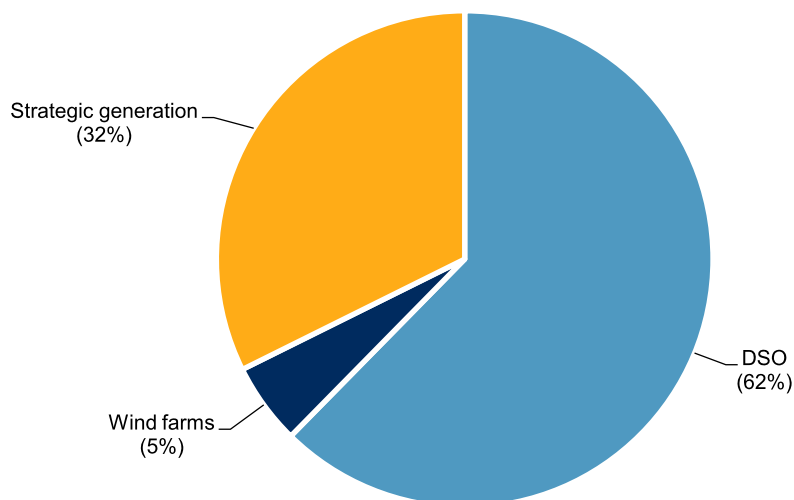
## **Company Description**

AB Ignitis Group is one of the largest international utilities and renewable energy companies in the Baltic region. Its core business activities are operating electricity and gas distribution networks, as well as expanding the green generation portfolio. It also manages strategically important flexible generation resources and provides customer- and solutions services. These include supplying electricity and gas, solar, e-mobility, energy efficiency, and other innovative energy smart platforms for households and businesses. The group generated revenue of €591 million for the first six months of 2020 under International Financial Reporting Standards. For the same period, the company distributed 4.7 terawatt hours of electricity to 1.6 million customers across Lithuania and generated around 0.95 terawatt hours of electricity. Ignitis 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 73.08% of the group.

Chart 2

### Ignitis Group's 2019 S&P Global Ratings-Adjusted EBITDA Breakdown



Source: S&P Global Ratings. DSO--Distribution system operator. Note: Includes Kaunas HPP and Kruonis PSHP. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

## Our Base-Case Scenario

### Assumptions

- Overall revenue growth of around 5% in 2020 based on favorable distribution tariff growth and a moderate decrease of electricity consumption as a result of the COVID-19 pandemic.
- Weighted-average cost of capital (WACC) will remain stable for the electricity segment, at around 5.3% in 2020-2021. WACC for the gas segment increased to 3.8% from 3.6% and is expected to remain stable.
- Power prices to remain around 30-35 euros per megawatt hour (€/MWh) in the Baltic region in 2020 with recovery during 2021-2023 to pre-crisis levels of 40-45 €/MWh.
- Capex of €380 million-€400 million in 2020 and €370 million-€380 million in 2021, higher than the historical average mainly due to construction works on VKJ, expansion of investments into the DSO network, and construction of renewables projects.

- Delay of about 18-24 months in commissioning of VKJ due to a delay choosing a new contractor to finish the biomass unit. We now expect the sale of up to 49% of VKJ in 2023.
- €75 million of dividends paid out during 2020. Declared dividend of €85 million for 2020, increasing by 3% in each subsequent year.
- Our forecast EBITDA figure includes temporary regulatory differences; historically generated and returned to customers in subsequent years.

## Key metrics

Table 1

### Ignitis Group--Key Metrics\*

|                                 | --Fiscal year ended Dec. 31-- |         |           |           |           |
|---------------------------------|-------------------------------|---------|-----------|-----------|-----------|
|                                 | 2018a                         | 2019a   | 2020e     | 2021f     | 2022f     |
| <b>(Mil. €)</b>                 |                               |         |           |           |           |
| Revenue                         | 1,024.3                       | 1,079.4 | 1100-1200 | 1300-1400 | 1300-1400 |
| EBITDA                          | 145.5                         | 205.2   | 260-280   | 280-300   | 280-300   |
| Funds from operations (FFO)     | 128.0                         | 185.8   | 240-260   | 260-280   | 250-270   |
| Capital expenditure             | 415.4                         | 427.5   | 380-400   | 370-390   | 350-370   |
| Free operating cash flow (FOCF) | (247)                         | (264)   | Negative  | Negative  | Negative  |
| Dividends                       | 80.6                          | 13.9    | 74.8      | 80-90     | 80-90     |
| Debt to EBITDA (x)              | 5.2                           | 4.8     | 2-3       | 2.5-3.5   | 3-3.5     |
| FFO to debt (%)                 | 16.8                          | 18.7    | 30-40     | 25-35     | 20-30     |

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

## Liquidity

We assess the company's liquidity as adequate, albeit supported by qualitative factors. These include strong bank support and the company's standing in credit markets, the ongoing benefit of its state ownership, and the expectation of near-term financing plans to offset the heavy 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 next 12 months.

Principal liquidity sources for the next 12 months starting Sept. 30, 2020:

- €272 million of unrestricted cash and cash equivalents.
- €256 million of cash FFO.
- €450 million of IPO proceeds.

Principal liquidity uses for the same period:

- €26.8 million of debt maturities.
- €370 million-€380 million of capex.

- €85 million of dividends.

## **Covenants**

Ignitis has a loan agreement with the European Investment Bank that includes several covenants, including maintaining an investment-grade rating.

## **Ratings Score Snapshot**

Issuer credit rating: BBB+/Stable/--

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

- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, 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: 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Research

- Lithuania's Electricity And Gas Regulatory Frameworks: Supportive, Oct. 6, 2020

## Ratings List

### Outlook Action; Ratings Affirmed

|                         | To             | From             |
|-------------------------|----------------|------------------|
| <b>AB Ignitis Group</b> |                |                  |
| 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](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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.



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