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Research Update:

Lietuvos Energija Outlook Revised To Negative On Weak 2018 Results; 'BBB+' Rating Affirmed

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Research Update:

Lietuvos Energija Outlook Revised To Negative On Weak 2018 Results; 'BBB+' Rating Affirmed

Rating Action Overview

- Lithuanian state-owned energy utility Lietuvos Energija UAB (LE) posted weaker credit metrics for 2018 than we had anticipated. Funds from operations (FFO) to debt fell to 17% from 46% in 2017, due to a weaker operating performance than we expected and a peak in the company's investment cycle.
- We continue to assume that LE will maintain its important role to the Lithuanian government as by far the country's largest power company.
- We are therefore revising our outlook on LE to negative from stable and affirming our 'BBB+' ratings on the company. We also affirmed the 'BBB+' long-term rating on LE's senior unsecured bonds.
- The negative outlook indicates the possibility of a downgrade over the next two years if there is no recovery in credit metrics, in particular FFO to debt rising back above 23%.

Rating Action Rationale

The outlook revision reflects the deterioration in LE's stand-alone financial performance. In 2018, the company's financial metrics were weaker than we had anticipated, primarily because of higher-than-expected purchased electricity prices, lower generation volumes, higher capital expenditure (capex) on green energy and grids, and small acquisitions in wind farms. Because LE is currently going through a heavy investment period, we expect FFO to debt to stay below 23% in 2019 (debt to EBITDA close to 5x) which is threshold for BBB+ rating.

We affirmed the rating because, under our current base case, we project LE's credit metrics will deteriorate only temporarily in 2018-2019 and rebound in subsequent years. The rating affirmation takes into account our expectation of moderately high likelihood of extraordinary support from the company's 100% owner, the Lithuanian government. Currently, it provides one notch uplift above LE's stand-alone credit profile (SACP), which we have revised down to 'bbb' from 'bbb+'. The rebound in credit metrics assumes that two combined heat and power (CHP) plants under construction will be commissioned on time and on budget, that LE's capex will decline closer to historical levels of below €300 million after 2020, and that the company will be successful in selling up to 49% of the Vilnius-based CHP plant, in line with current plans.

Although we already anticipated a certain weakening in LE's credit metrics in

2018-2019 due to a peak in investments, the actual deterioration was more significant than expected. This reflected a combination of factors:

- A sharp increase in electricity purchase prices, which resulted in a substantially higher cost of electricity purchased (€49 per megawatt hour [/MWh] compared with €35/MWh in 2017). LE purchases all of its electricity on the market, on the Nordpool.
- Lower volumes of generated electricity mainly due to unfavorable weather conditions (1.01 terawatt hours [TWh] in 2018 down from 1.28 TWh in 2017).
- Increase in gross capex (including government grants and subsidies) to €439.5 million in 2018 from €233 million in 2017. This was mainly due to higher investments in the two CHP plants, the acquisition of three wind farms, and one development project, and modernization of the distribution systems operator (DSO) network. The capex was mostly funded by new debt--€300 million of green bonds issued in July 2018 and extension of the existing credit line with Swedbank.

As a result, FFO to debt fell to about 17% in 2018 from 46% in 2017 and debt to EBITDA increased to 5.2x from 2.0x. Under the Lithuanian regulatory framework, LE will recover the temporary regulatory differences caused by the gap between actual and projected electricity prices in 2020, adding €34 million to EBITDA. We expect the company's ratios to remain under pressure in 2019, with FFO to debt just below 20% as LE will continue high capex in building two waste- and biomass-fired plants: Vilnius CHP Plant (VKJ) and Kaunas CHP Plant (KKJ). The new plants will increase the company's (and the country's) energy self-sufficiency, reduce dependency on electricity imports, and have a positive environmental impact. We forecast adjusted debt will increase to about €1 billion by the end of 2019 from €760 million currently. We expect both plants to be fully operational by 2020, but we can't rule out construction risks. We also expect both CHP plants to be very competitive, as they will mostly burn waste and provide about 40% of district heat demand in Lithuania's two largest cities, Vilnius and Kaunas. As agreed with the European Commission, the Lithuanian government has confirmed that a tender to sell up to 49% of VKJ will be organized within 180 days of the completion of the project.

Although we forecast discretionary cash flows to debt to be significantly negative until the end of 2019 (around -40%), from 2020 we forecast a recovery once the CHP plants are constructed and fully operational. This should also lead to a recovery in credit measures, and we assume FFO to debt will rebound back to 23% in 2020 and close to 30% in 2021. Prospects for a recovery in metrics are further supported by our expectation of:

- A boost to EBITDA from compensation for the differences between projected and actual electricity prices;
- The end of the heavy investment cycle, after the two CHP plants are completed;
- The divestment of noncore assets;

- The sale of up to 49% of VKJ; and
- Growth in EBITDA on the back of growth in the regulatory asset base (RAB) resulting from heavy investment in the distribution network.

A supportive and predictable regulatory framework remains the key credit factor supporting our assessment of LE's satisfactory business risk profile. The current five-year regulatory period ends in 2020 for electricity distribution (73% of the group's 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. Only guaranteed supply is based on the market price plus 25%. As for LE's unregulated generation and supply business (about 20% of EBITDA), we see it as more credit-dilutive. 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 LE as a government-related entity (GRE). In accordance with our methodology for rating GREs, our rating on LE incorporates our assessment of a moderately high likelihood that Lithuania would provide timely and sufficient extraordinary support to LE in the event of financial distress, reflecting our assessment of LE's:

- Important role: LE is essential to the Lithuanian government and the country's energy security with market shares of 86% in electricity distribution and 31% in generation. Although the household supply market will open for competition in 2020, we expect LE will remain the biggest market participant.
- The company's link to the Lithuanian government is strong since it is a 100%-owned entity of the government via the Ministry of Finance. There is ongoing support from the government, including the gradual repayment of a large receivable resulting from the sale of LE's transmission system operator to the government in 2012.

Outlook

The negative outlook reflects our belief that we could lower the ratings during the next two years if the current deterioration in financial metrics does not reverse and FFO to debt stays below 23% with no visible prospects of recovery. We expect LE's financial performance to remain weak in 2019, with FFO to debt temporarily falling below 20% due to sizable debt-financed investments, mainly related to the construction of the CHP plants, and only gradual EBITDA growth. It also factors in project execution risks and further potential small acquisitions. For the current rating, we expect that the regulatory and operating environment will continue to be supportive and the majority of cash flows will mainly come from low-risk distribution business and supportive financial policy. We also assume that the company's liquidity will remain adequate, with no issues related to covenant waivers or

renegotiation.

Downside scenario

We could lower the ratings if LE's financial and operating performance materially deviates from our base case, leading us to revise down its SACP. This could result from:

- Weaker and more volatile cash flows, such that FFO to debt deteriorates significantly below 23% without any prospects for rapid recovery;
- LE being unable to sell 49% of VKJ in 2020;
- LE engaging in a large debt-financed acquisition while its heavy investment program is still underway; or
- Liquidity comes under pressure.

We could also lower the rating if there is a reduction in the likelihood of extraordinary support from the Lithuanian government, which we currently do not expect. Finally, we could consider a downgrade if LE receives no working capital inflow from the EPSO-G group of state-owned energy transmission and exchange companies in 2019 (LE sold its transmission grid operator to EPSO-G in 2012 and is expecting gradual repayments).

Upside scenario

We see ratings upside as limited in the next two years, due to the company's significant capex program. We would revise our outlook to stable if we believed the company's credit metrics are set to recover, with FFO to debt at above 23%, which could happen in case of stronger EBITDA generation, capex savings, lower leverage, or the prompt receipt of the EPSO-G receivable.

Company Description

Lietuvos Energija UAB is one of the largest energy companies in Lithuania, operating in electricity and gas distribution and electricity generation and supply businesses. LE generated revenue of €1.25 billion in 2018 under International Financial Reporting Standards (IFRS). In 2018, the company has distributed 9.6 TWh of electricity to 1.6 million customers across Lithuania and it accounts for 86% of market share.

Our Base-Case Scenario

- Electricity demand will increase by about 2% annually, supported by GDP growth.
- The weighted-average cost of capital (WACC) will remain stable for the electricity segment at about 5% in 2019-2021. WACC for gas segment has lowered to 3.6% from 7.1% with the beginning of a new regulatory period

in 2019. We expect the WACC to be stable going forward.

- Power prices will be €44/MWh-€46/MWh in the Baltic region over 2019-2020.
- Capex to be €360 million in 2019, higher than historical average mainly due to construction works on KKJ and VKJ and expansion of investments into DSO network. From 2020, we expect capex of below €300 million, with most of this being invested in the distribution network.
- Lower dividend payout in 2019 following weaker 2018 results as confirmed by the Ministry of Finance. From 2020, a dividend payout of about 70% of retained earnings, depending on the level of LE's return on equity.
- Our forecast EBITDA figure includes temporary regulatory differences; historically, these have been generated and returned to customers in subsequent years.
- The successful sale of up to 49% of VKJ within 180 days of the completion of the project.
- Stable generation volumes going forward at about 1.1 TWh.

Liquidity

We assess the company's liquidity as adequate, with the ratio of liquidity sources to liquidity uses at 1.2x. The supportive qualitative factors 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 12 months from March 31, 2019.

LE's principal liquidity sources for the 12 months from March 31, 2019, are:

- €150 million of unrestricted cash and cash equivalents;
- €103 million of undrawn committed bank lines maturing in May, 2020;
- €196.3 million of cash FFO; and
- €70.7 million of government grants to be received.

LE's principal liquidity uses for the same period are:

- €62.3 million of debt maturities;
- €125.5 of working capital outflow;
- €260 million of maintenance capital expenditures; and
- €23.7 million of dividends.

Covenants

The company has a loan agreement with the European Investment Bank (EIB) that

includes a number of covenants, including net debt to adjusted EBITDA, which should not be higher than 4.0x. As of Dec. 31, 2018, LE was compliant with this covenant (based on the EIB's calculation of EBITDA). That said, we understand that LE received a waiver from the EIB for 2019 and 2020. LE has sufficient cash and cash-equivalent reserves and undrawn committed credit lines to serve its debt obligations in full. Therefore, we continue to view liquidity as adequate.

Environmental, Social, And Governance

The rating on LE incorporates both social and governance factors, whereas environmental factors are less relevant.

From an environmental point of view, LE's business risk benefits from prevailing network assets in the electricity DSO segment having zero net emissions. Most of the company's electricity generation comes from renewables (hydro power plants and wind farms) with two biomass or waste-fired plants expected to come on-stream in 2020. The company's gas-fired (prevailing) and oil-fired (marginal) power plants are only operating to balance the output if necessary. We understand that LE monitors the risks gas leakage from distribution networks or from the LNG terminal (owned by Klaipedos nafta), where LE is sole operator and is in full compliance with applicable environmental regulations.

Social factors are highly important for LE because maintaining a reliable, safe, and viable economic network is key to managing regulatory risk and public opinion. The company used to have solid track record of compliance with all regulatory requirements, but in 2017 LE failed a regulatory requirement for its gas distribution segment, SAIDI (the System Average Interruption Duration Index). Since 2018, it is in compliance with all regulatory requirements and we expect this to continue.

From the governance standpoint, the company is fully owned by the Lithuanian government and its activities are strongly aligned with government's policy of energy self-sufficiency. The extraordinary government support provides one notch of uplift to the company's SACP.

Issue Ratings - Subordination Risk Analysis

Capital structure

LE's capital structure comprises €600 million senior unsecured debt issued at the parent level together with unrated debt of €156.9 million and €88.1 million issued by its subsidiaries.

Analytical conclusions

LE's debt is rated '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

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Group Rating Methodology, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Lietuvos Energija UAB		
Issuer Credit Rating	BBB+/Negative/--	BBB+/Stable/--
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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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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