Research Update:

Eesti Energia Downgraded To 'BB+' From 'BBB-' On Elevated Leverage Expectations; Outlook Stable

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Rating Action Overview

- Eesti Energia reported weaker-than-expected unaudited EBITDA in 2024, and we expect it will remain in the €390 million-€430 million range in 2025-2027.
- We view the company's profitability in unregulated business (expected 70% of EBITDA on 2025-2027) as volatile and hard to predict.
- We expect high interest, negative working capital, and dividends to lead to S&P Global Ratings-adjusted funds from operations (FFO) to debt at about 20% on average on 2025-2027, despite reduced capital expenditure (capex) to €360 million in 2025 and less than €200 million in 2026-2027, from €722 million in 2024.
- As a result, we lowered the issuer credit rating on Eesti Energia to 'BB+' from 'BBB-' and the junior subordinated rating on the €400 million hybrid instrument to 'B' from 'B+'.
- The stable outlook indicates we expect FFO to debt to remain above 19% in 2025-2027 on average, with sustained 30% EBITDA contribution from regulated power distribution network activities.

Rating Action Rationale

We expect Eesti Energia's adjusted EBITDA to remain at €390 million-€430 million on average in 2025-2027, roughly in line with 2024 because lower shale oil results will be partly mitigated by higher renewable capacity. The company reported €398 million EBITDA for 2024, including a one-off €73 million gain on free carbon dioxide (CO_2) emission allowances, which we expect will not repeat in 2025-2027. The 2025-2027 EBITDA level will be sustained at around €400 million. This is thanks to stable and slightly increasing power distribution business contributing about €125 million annual EBITDA. It also owes to gradually increasing renewable power production from 1.9 terawatt hours (TWh) as of year-end 2024 to about 3 TWh on 2026-2028 with new projects commissioned, for about €140 million-€180 million EBITDA on 2025-2027. We assume stable power prices within our base-case scenario with power prices in the Baltics at around €80-€90 per megawatt hour (€/MWh) in 2025-2027. Furthermore, due to their high cost basis and pollution, oil shale units are unprofitable at below €120-€140/MWh, we expect Eesti Energia's flexible power production will remain at about 1.5-1.9 TWh on 2025-2027, serving as back up units when peaks in demand lead to higher prices. Eesti Energia's unregulated electricity business margins remain exposed to market prices as electricity purchases need to cover for production volumes (about 4.5 TWh expected) remaining significantly lower than retail volumes sold (about 10 TWh), weakening its integrated position. Eesti Energia's Enefit 280-2 shale oil production plant is scheduled for completion in 2025 and will increase Eesti Energia's annual output of liquid fuel, reaching full capacity by 2026 in our base case, but we consider it has a limited impact on EBITDA growth.

Large capex cuts should contain debt increase to about €100 million on 2025-2027. We expect FFO to debt to stay at about 20% in 2025-2027, a level we view commensurate with the 'bb-' stand-alone credit profile (SACP). Based on our preliminary estimate of 2024 year-end adjusted debt of €1.4 billion, a high average interest rate of 5.26% prompts sustained interest expense. Negative working capital of about €50 million annually weighs on free cash flow generation. At year-end 2025, we estimate our adjusted debt will amount to €1.5 billion, almost double the 2022 level.

We now expect investments of about €1.5 billion over 2024-2028 from €2.5 billion-€3.0 billion over 2022-2026 in our previous base case. Large projects like the new Enefit 280-2 oil production plant will be completed in 2025, and in order to protect leverage, we now expect the company will cut uncommitted growth capex related to renewable projects from 2025. This also reflects challenges in developing renewable projects because their rates of return are too low based only on merchant prices. Although protecting any further debt increase, the postponement of capex would keep the group from achieving its decarbonization targets and renewable EBITDA growth after 2028.

High volatility in Eesti Energia's cash flow generation due to large retail exposure, a relatively small scale, and uncertainty on future generation remuneration supports the downgrade to 'BB+'. The company's integrated margin is exposed to market price volatility, as low power production means more sourcing at market prices for its supply activities and, if production weakens materially in renewables, to cover for as-consumed power purchase agreement contracts. We also see a risk that Eesti Energia would need to keep its unprofitable oil shale power plants available to ensure security of supply in the country without adequate short-term remuneration. Strategic reserve compensation mechanism is being discussed with the state and the national transmission system operator Elering but its implementation is dependent on State aid approval from the European Commission for which timing is uncertain. We view as positive advancements toward a frequency reserve and island mode remuneration, expected to be implemented by 2026. However, uncertainty remains on the dispatchable units remuneration for flexibility service, timing of implementation, and on potential additional supportive remuneration mechanisms to incentivize renewable development.

We expect the likelihood of support from the Estonian government to remain moderately high as the company is at the forefront of national energy objectives. We do not include a capital injection or dividend cuts in our base case as we believe such support from the Estonian state is uncertain and could go along additional capex. We continue to assess the likelihood of extraordinary government support to Eesti Energia as moderately high, based on our assessment of the company's:

- Strong link with the Estonian government, which owns 100% of Eesti Energia, with no expected change.

- Important role for the government, given that Eesti Energia's operations are strongly aligned with the government's interests, in particular ensuring that Estonia is self-sufficient in electricity.

Outlook

The stable outlook reflects our expectation that FFO to debt will be about 20% in 2025-2026. This expectation is underpinned by lower power prices, with rollout of profitable hedges in 2024, and a sustained high debt level around €1.4 billion -€1.5 billion. We expect discretionary cash flow to gradually improve by 2027 thanks to capex cut.

Downside scenario

We could lower the rating if Eesti Energia's operating and financial performance deteriorate without sufficient prospects for near-term recovery, with FFO to debt falling sustainably below 19%. This could arise from:

- Power prices decreasing below €70/MWh in 2025-2027 leading to weaker generation earnings on merchant-exposed production as hedges are rolled over;
- Low power production on renewables and thermal units;
- Squeezed retail margins; and
- Increased investment or cost overruns--absent sufficient remedial measures like subsidies, proceeds from disposals, or dividend cuts.

We could also downgrade Eesti Energia if the volatility of its cash flow generation increases, notably alongside:

- Material decreases in regulated networks' EBITDA contribution, for example from adverse regulatory decisions;
- Delays in phasing out highly polluting oil shale plants with absence of supportive remuneration.

Weakening liquidity and any issues with covenant waivers could also pressure the rating. However, this is not our current base-case expectation.

Upside scenario

We could raise the rating on Eesti Energia if FFO to debt stabilizes above 25%, provided the business position does not weaken.

This would most likely result from:

- Stronger operating results due to higher Estonian area power prices, operating efficiencies for power generation, or positive revisions to the regulatory framework for electricity distribution; or
- Ongoing government support, for example in the form of dividend cuts or capital injections.

We could also raise the rating if FFO to debt stabilizes above 25% and Eesti Energia's cash flow volatility materially decreases based on:

- A higher share of earnings from regulated network activities;

- Capacity market mechanism, ensuring the continuity of supply during peak periods, on strategic reserve thermal plants; and;
- Lower market price exposure with renewable generation contracts representing the bulk of cash flows.

Finally, should we perceive a higher likelihood of extraordinary support from the Estonian state, for example with guarantees on Eesti Energia's debt or material equity injections, we could raise the rating by one notch.

Company Description

Eesti Energia AS is a vertically integrated energy company based in Estonia, with limited international operations. It is 100% owned by the Estonian government. The company's main operation areas are:

- Electricity generation, with about 3.8 TWh of capacity;
- Oil shale production of about 451,000 metric tons;
- Electricity distribution, including 93% coverage in Estonia; and
- Related customer solutions.

Reported EBITDA amounted to €398 million in 2023. On average, about 60% of EBITDA comes from electricity and heat generation and the supply of electricity in Baltic countries; about 30% from regulated electricity distribution in Estonia; and 10% from natural gas sales, oil shale production, and other services, also mostly in Estonia. Unaudited reported EBITDA for 2024 amounted to €398 million.

Our Base-Case Scenario

Assumptions

- Estonian real GDP to expand by 1.9% in 2025, 2.5% in 2026 and 2.1% in 2027.
- Inflation: Consumer price index easing to 4.2% in 2025, 3.6% in 2026 after a high 2.2% in 2027.
- Subsidiary Enefit Green is 100% consolidated, despite the 22.8% minority interest.
- Nord Pool electricity price in the Baltics remaining at about €80-€90/MWh in 2025-2027.
- Electricity generation:

--Renewable generation at about 2.5 TWh on 2025 and increasing to around 3.5 TWh in 2027.

--Thermal generation remaining at around 1.5 TWh -2 TWh in 2025-2027

Distribution system operation activities:

--Average distribution tariff to remain stable during 2025-2027 with WACC around 6.3%.

--Stable volume levels over 2025-2027.

- EBITDA margin at about 18% on 2025-2027.
- Cost of debt at about 5.5%-6.6% on 2025-2027.

- Net capex of about €360 million in 2025, then about €150 million-€200 million annually in 2026 and 2027.
- Dividends of about €40 million -€70 million in 2025-2027, including dividends paid from Enefit Green to minority shareholders.
- We exclude any potential capital injection from the State from our base case.

Key metrics

Eesti Energia AS--Forecast summary

Period ending	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025	Dec-31-2026	Dec-31-2027
(Mil. EUR)	2022a	2023a	2024p	2025f	2026f	2027f
EBITDA	343	430	398	390-410	380-410	400-430
Less: Cash interest paid	(19)	(60)	(96)	(100)-(85)	(90)-(75)	(90)-(75)
Less: Cash taxes paid	(12)	(25)	(8)	(9)-(11)	(15)-(30)	(20)-(30)
Funds from operations (FFO)	312	371	294	270-300	270-300	290-330
Capital expenditure (capex)	454	691	615	350-400	150-200	140-190
Dividends	56	82	88	50-60	70-90	60-80
Debt	796	1,543	1,424	1,500-1,600	1,550-1,650	1,500-1,600
Adjusted ratios						
Debt/EBITDA (x)	2.3	3.4	3.6	3.8-4.0	3.8-4.1	3.4-3.6
FFO/debt (%)	39.2	24.0	20.7	18-20	18-20	20-22

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. p--Preliminary. f--Forecast. EUR--euro.

Liquidity

We consider Eesti Energia's liquidity to be adequate, based on our estimate that cash sources will cover uses by more than 1.2x over the 12 months started Jan. 1, 2025 and our expectation that the company will negotiate successfully waivers on its covenants in case of breach. The debt maturity profile is relatively staggered, as Eesti Energia has a €600 million loan, of which €300 million matures in February 2028 and €300 million is amortizing.

Principal liquidity sources

Principal liquidity sources over the 12 months started Jan. 1, 2025, include:

- Cash and cash equivalents of about €470 million.
- Undrawn committed revolving credit facility and long-term loan agreements of €165 million maturing in more than one year.
- Our forecast of cash FFO of about €305 million.

Principal liquidity uses

Principal liquidity uses for same period include:

- Debt maturities of about €169 million.
- Working capital outflow of €63 million.
- Committed capex of about €460 million.
- €40 million dividend.

Covenants

The company's €600 million syndicated loan documentation includes a default covenant based on a maximum adjusted net leverage ratio of 3.5x along with a minimum debt service coverage ratio of 1.2x, both tested semi-annually. We see a risk that the 3.5x net leverage ratio covenant could be breached in 2025. Eesti Energia has a track record of obtaining waivers for its covenants and we expect it will do so and prevent a breach in 2025. We will closely monitor the situation as well as any negotiation process.

Environmental, Social, And Governance

Environmental factors are a highly negative consideration in our credit rating analysis of Eesti Energia. Its emissions are higher than those of many rated peers in Europe, at about 340 grams of CO_2 per kilowatt hour (KWh) (gCO_2/KWh) for its total energy production and 440 gCO_2/KWh for electricity production. This ranks Eesti Energia at about the same level as Electricity Supply Board (378 gCO_2/KWh) but with higher pollution than CEZ a.s. (330 gCO_2/KWh) and Fortum including Uniper (320 gCO_2/KWh). That said, the company aims to increase its share of electricity generated from renewable sources to at least 80% by 2030, and targets carbon neutrality by 2045, which is in line with the Paris Agreement. However, the company plans to continue using shale oil in thermal power plants, but to phase out this energy source during 2026-2030. This, in our view, places Eesti Energia in the bottom tier of performers when it comes to the energy transition.

Issue Ratings--Subordination Risk Analysis

Capital structure

Eesti Energia has about 40% of its debt at Enefit Green, there is limited subordination risk.

Eesti Energia issued a €400 million hybrid in July 2024.

Analytical conclusions

Rating Component Scores

Rating Component Scores

Component	
Foreign currency issuer credit rating	BB+/STABLE/--
Local currency issuer credit rating	BB+/STABLE/--
Business risk	4 - Fair
Country risk	3 - Intermediate Risk
Industry risk	3 - Intermediate Risk
Competitive position	4 - Fair
Financial risk	4 - Significant
Cash flow/leverage	4 - Significant
Anchor	bb
Diversification/portfolio effect	3 - Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile	bb

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, Feb. 10, 2025
- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, 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 | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

Eesti Energia AS , Oct. 15, 2024

Research Update: Eesti Energia AS 'BBB-' Ratings Affirmed; Outlook Negative, Nov. 24, 2022

Ratings List

Ratings list		
Downgraded; Outlook Action		
	To	**From**
Eesti Energia AS		
Issuer Credit Rating	BB+/Stable/--	BBB-/Negative/--
Downgraded		
	To	**From**
Eesti Energia AS		
Junior Subordinated	B	B+