Research Update:

Estonian Utility Eesti Energia Outlook Revised To Stable From Negative On Refinancing And Strong 2022 Performance

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*(**Editor's Note:** We republished this report, previously published on March 2, 2023, to clarify our interest rate assumption.)*

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Rating Action Overview

- On Feb. 15, Eesti Energia refinanced its €500 million bond maturing Sept. 22, 2023, with a €600 million syndicated sustainability linked loan maturing in February 2028.
- Although Estonian power prices in first-quarter 2023 moderated to close to €100 per megawatt-hour (/MWh), compared to average of €190/MWh in 2022, we expect Eesti Energia's earnings and cash flows will remain strong through 2024.
- We assume the utility will post S&P Global Ratings-adjusted EBITDA of €400 million-€500 million in 2023 and 2024, up from €270 million in 2021 and in line with 2022's €420 million reported EBITDA. For 2023 we expect funds from operations to debt (FFO) slightly above 25%.
- As a result, S&P Global Ratings revised its outlook to stable from negative, and affirmed its 'BBB-' issuer credit rating on Eesti Energia and its 'BBB-' issue rating on the utility's debt.
- The stable outlook indicates that we expect the company's credit metrics to return to close to historical levels from 2023, with FFO to debt just above 25% on average in 2023 and 2024, following 2022's spike to about 50%.

Rating Action Rationale

The outlook revision follows Eesti Energia's securing refinancing of its €500 million bond due September 2023, which provides a healthy extension to its debt maturity profile. With the new €600 million sustainability-linked syndicated loan maturing in 2028, the company has increased the weighted-average maturity of its debt to 4.3 years, and pushed off near-term liquidity risks given the bond's September maturity. We view positively the company's agreement for the sustainability loan. Thanks also to higher power prices in the region, we continue to forecast strong operating cash flow for 2023. We estimate FFO of €350 million-€450 million up from €272 million in 2021, and near the €380 million in 2022, which support the utility's ability to fund its large capital expenditure (capex) plan of about €800 million annually on average in 2023 and 2024. Eesti Energia also benefits from €270 million of credit facilities maturing beyond 2025. This liquidity is largely sufficient to service uses over the next 12 months and we view the utility as capable of facing a stressed scenario with limited refinancing needs, also thanks to some flexible in its renewable capex plan.

We affirmed the 'BBB-' rating because we believe Eesti Energia will maintain some rating headroom thanks to high power prices, as 2022 results confirmed. Despite higher interest expense due to refinancing at what we assume will be 4.0%-5.0% versus the 2023's bond interest of 2.3%, the utility's credit metrics remain fully in line with our requirements for the rating level (for more information, see "Eesti Energia AS 'BBB-' Ratings Affirmed; Outlook Negative," published Nov. 24, 2022, on RatingsDirect). We continue to expect Eesti Energia's credit ratios to benefit from historical high electricity prices, albeit at a lower €130/MWh in 2023 compared with €200/MWh in 2022, including a smoothing effect from hedges partially locking prices for 2023 and 2024. We forecast FFO to debt will have peaked at the end of 2022 at close to 50%, then will stabilize at 25%-30% from 2023-2024. In 2022, the utility reported EBITDA of €420 million, up 32% from 2021's level. This growth came from strong performance in the electricity segment based on high average selling prices including derivatives of €140/MWh in 2022 (up 73% from 2021) resulting in EBITDA of €286 million (up 32%) and high selling price in natural gas for €73.5 million EBITDA (up 1,297%). It has been partly offset by deterioration in distribution margins due to high energy costs of network losses (EBITDA of €52 million, down 40% from 2021) while low prices hedged for shale oil production kept its EBITDA from benefiting from the higher prices (a negative €12 million EBITDA compared with positive €8 million in 2021).

The ambitious investment plan is likely to result in a diluted share of earnings from regulated activities and increase Eesti Energia's exposure to market prices and electricity generation. The company's strategy entails investment of €2.5 billion-€3.0 billion over five years (2022-2026) with a major rise in capex starting from 2022, with €454 million, to a peak of €800 million-€1 billion in 2023, compared with €217 million in 2021. We understand Eesti Energia will direct the majority of its investments into renewable generation under its recently listed subsidiary, Enefit Green AS, which is 77.2% owned by Eesti Energia. Depending on power prices, we foresee that its regulated activities--namely networks and its flexible generation, which we perceive as more stable and predictable--could represent less than 30% of consolidated EBITDA compared with about 40% historically. This is in part due to the higher prices, but also the higher share of investment in generation assets, representing a strategic shift. This will weigh negatively on Eesti Energia's business risk, in our view, but we expect regulated earnings will still constitute a meaningful stake of 20%-30% on average and remain a cornerstone of the utility's strategy. We also expect EBITDA from networks to be relatively stable at €70 million-€85 million annually as energy costs for network losses stabilize in 2023-2024, and that the company will continue to invest at least €60 million-€70 million annually in regulated assets. This somewhat mitigates the increasing market risk exposure from its expansion into renewable generation. We therefore anticipate the share of regulated earnings in total EBITDA will remain above 20% on average.

Eesti Energia focuses on expanding renewable generation capacity through subsidiary Enefit Green. The company seeks to reduce its carbon exposure by investing heavily in low-carbon activities, such as renewable power generation, distribution grid operations, and related network services, such as high-speed internet. Eesti Energia updated its new strategic plan in May 2022, under which the company is focusing more on renewable electricity and reducing the carbon footprint in markets such as Finland and Poland. Its previous strategy included the addition of 600 MW of wind and solar parks by 2025, which takes the total installed capacity to 1,100 MW. The updated strategy includes a 4x increase from the current installed capacity to 1,900 MW by 2026. This is a very ambitious strategy and we will monitor the progress as Eesti Energia adds new renewable capacity. We include in our forecast the company's full investment plan. This results in free operating cash flow (minus capex) to debt of about 6.5% in 2022 and negative 35% in 2023-2024. Nevertheless, the company has historically overguided expected spending, and a fairly large share of the planned capex remains uncommitted. The high inflation in Estonia, which was at 22.5% in October, is likely to remain elevated through 2023, which could result in pressure on spending.

Following the IPO in 2021, the group structure became more complex. Eesti Energia has 77.2% ownership of Enefit Green but will have limited access to the cash at the subsidiary. The group structure also introduces subordination risk for EE, but we expect priority debt to remain below 50% in the coming year. We continue to fully consolidate Enefit Green in our analysis, since we expect the proportional deconsolidation effect to have only a minor-to-modest effect, and Eesti Energia has effective full control of Enefit Green through the board of directors so can modify, among other things, investment and dividend policies. There is no material difference in credit ratios compared with a proportional deconsolidation of Enefit Green. This is because debt will be raised at both Enefit Green and Eesti Energia.

Outlook

The stable outlook indicates that, although we forecast Eesti Energia will post strong credit metrics for 2022 because of strong power price momentum, we expect FFO to debt temporary well above 25%, which is commensurate with the 'bb' stand-alone credit profile, before it returns to 25%-30% in 2023 as power prices moderate and investment rises. Given the sizable investment program, we expect discretionary cash flow (DCF) to be negative at €600 million-€700 million in 2023.

We have not changed our view that there is a moderately high likelihood that the Estonia would offer Eesti Energia extraordinary support, in case of need. Moreover, we factor into our assessment that the company appears to be committed to an investment-grade rating, notably with FFO to debt above 25%.

Downside scenario

We could lower our ratings if liquidity were to come under pressure or operating and financial performance deteriorate without prospects for short-term recovery, with FFO to debt falling sustainably below 25% for a prolonged time.

We could also lower the ratings if:

- The company engaged in large debt-financed investments.
- A meaningful increase of the minority interest in Enefit Green leads to more pronounced differences between the full and proportional consolidation of the subsidiary in credit ratios; or
- Increased political risk depressed Eesti Energia's financial metrics and led to a largely negative DCF-to-debt ratio, for example (although this is not our base-case scenario).

Upside scenario

We could raise the rating if:

- Eesti Energia's credit metrics strengthened beyond 2024, such that we forecast FFO to debt sustainably above 30%, although this is not our base-case scenario due to the large capex plan in renewables; and
- Its business position does not weaken with the company developing renewable and showing advancement in its decarbonization strategy.

Company Description

Eesti Energia is a vertically integrated energy company based in Estonia, with operations mainly in the Baltics, but also Finland, Poland, and the U.S. It is 100% owned by the Estonian government. The group's main operation areas are electricity generation with about 5.2 terawatt-hours (TWh) of generation, shale oil production of about 438,000 metric tons, electricity distribution with 93% coverage in Estonia, and customer solutions. Reported EBITDA amounted to €420.4 million in 2022. 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 sale, shale oil production and other services. With increasing oil production and higher power prices, we expect the share of unregulated operations in EBITDA to increase, with the contribution from regulated operations forming a relatively smaller part.

Our Base-Case Scenario

Assumptions

- Estonian real GDP to have contracted by 0.5% in 2022, and expand by 0.2% in 2023, and 2.9% in 2024.
- Inflation: Consumer price index easing to 8.9% in 2023 and 3.5% in 2024 after a high 19.5% in 2022.
- Subsidiary Enefit Green to be 100% consolidated, despite the divested 22.8% minority interest.
- Nord Pool electricity price in Estonia falling to €100-€140/MWh in 2023 and 2024 after €180-€200/MWh on average in 2022 (all Eesti Energia figures for 2022 are preliminary).
- Electricity generation:
- --Renewable generation of 1.5 TWh and 2023 and about 3.7 TWh in 2024, following 1.5 TWh in 2022.
- --Thermal generation decreasing toward 2.5 TWh afterward because of the closing of old thermal plants. It was 4.8 TWh in 2022.
- Distribution system operator (DSO) activities:
- --Average distribution tariff being stable from 2022-2024.
- --Stable volume levels over 2022-2026.

- EBITDA margin of 15%-25% in 2022-2026.
- A new €600 million loan in 2023.
- Capex of about €1.94 billion in 2023 and €615 million 2024 (following €500 million in 2022).
- Dividends of €56 million in 2022, €107 million in 2023, and about €90 million in 2024, with a payout ratio of 50% of the previous year's net income.

Key metrics

Eesti Energia AS--Key Figures

	--Fiscal year ended Dec. 31 --				
(Mil. €)	2020a	2021a	2022p	2023f	2024f
EBITDA	204.6	292.9	421	420-440	500-580
FFO	179.6	272.6	383	360-380	420-500
Capital expenditure	173.6	217.5	454	950-1,050	550-650
Dividends	0	0	56	155-165	195-205
Debt to EBITDA (x)	4.3	2.7	1.9	3.3-3.5	2.6-2.9
FFO to debt (%)	20.6	34.8	48.3	25-30	25-30

*All figures adjusted by S&P Global Ratings. FFO-- Funds from operations. a--Actual. p--Preliminary. f--Forecast.

Liquidity

We consider Eesti Energia's liquidity adequate, based on our estimate that cash resources will cover uses by about than 1.25x over the 12 months from Dec. 31, 2022. The figure includes the recent refinancing. The utility and Enefit Green have separate financing, implying Eesti Energia cannot freely access cash at Enefit Green.

Eesti Energia's refinancing took several months to complete, and the company has been forced several times to change its refinancing strategy. The utility failed accessing the public bond market in second-quarter 2022 due to Estonia's location next to neighboring Russia. Due to the company's shale oil generation and increasing scope 3 emissions, one of its core banks decided to leave the lending group in November 2022, which further extended the refinancing process. We therefore don't believe the relationships with banks or its standing in credit markets are as robust as before. Positively, we believe that management has been proactive, as it started the refinancing process about 18 month ahead of bond maturity. We also believe it benefits from its position as the largest power producer and from the ownership of the majority of Estonia's DSO operations, which is critical infrastructure with typically very stable cash flows. Lastly, Eesti Energia attracted new banks and the loan was fully subscribed by a mix of banks for which it has a long relationship and a few new. Further sales of share in Enefit Green is also a source of potential liquidity, if needed. Following the IPO, the liquidity setup has changed significantly, since Eesti Energia cannot freely access the cash and credit facilities at Enefit Green. In our analysis, we exclude those sources.

Eesti Energia complies under the 3.5x adjusted leverage and 1.2x debt service cover covenants of the new syndicated loan.

We expect principal liquidity sources over the 12 months from Dec. 31, 2022, will include:

- Cash and cash equivalents of about €276 million;
- Undrawn RCF of €250 million maturing in more than one year;
- Our forecast of cash FFO of about €400 million; and
- €600 million from the new syndicated loan signed Feb. 15, 2023.

We expect principal liquidity uses for the same period will include:

- Debt maturities of about €550 million of which €500 million bond matures Sept. 22, 2023;
- Committed capex of about €300 million; and
- About €100 million in dividends.

Covenants

The company's new loan is governed by a maximum adjusted net leverage ratio not to exceed 3.5x along with a minimum debt service coverage ratio of 1.2x, both tested quarterly. Based on our forecast, we expect Eesti Energia will remain compliant.

Environmental, Social, And Governance

ESG credit indicators: E-5, S-2, G-2

Environmental factors are a very negative consideration in our credit rating analysis of EE. The utility's emissions remain higher than many rated peers in Europe, at about 550 grams (g) of carbon dioxide per kilowatt-hour (CO_2/kWh) for its total energy production and 880g CO_2/kWh for electricity production. This had increased in 2022 with the heavy use of thermal generation in a context of high power prices. This ranks the utility worse than Electricity Supply Board (378g CO_2/kWh) and CEZ a.s. (330g CO_2/kWh). Still, the company aims to increase its share of electricity from renewable sources to at least 80% by 2030, and targets carbon neutrality by 2045, which is in line with the Paris Agreement. The company plans to continue using oil shale in thermal power plants, but phase it out during 2026-2030. We think this places it among the worst performers when it comes to the energy transition.

Issue Ratings - Subordination Risk Analysis

Capital structure

Eesti Energia's debt remains mostly at the parent company level but could grow at Enefit Green to fund investment in renewables. Total debt stood at €1.06 billion as of end-2022. Enefit Green has debt of €275 million, equivalent to about 26% of total debt.

Analytical conclusions

The 'BBB-' issue rating on Eesti Energia's senior unsecured debt is in line with the issuer credit rating because no elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating	BBB-/Stable/--
Business risk	Fair
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Fair
Financial risk	Significant
Cash flow/leverage	Significant
Anchor	bb
Modifiers	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bb
Related government rating	AA-/Negative/A-1+
Likelihood of government support	Moderately high (+2 notches)

Related Criteria

- 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 | 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
- 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: Industry Risk, 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

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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Eesti Energia AS		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Negative/--
Senior Unsecured	BBB-	BBB-