Research Update:

Latvian Transmission Operator AST Upgraded To 'A-' On Improving Liquidity; Outlook Stable

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PRIMARY CREDIT ANALYST

Emeline Vinot
Paris
+ 33 014 075 2569
emeline.vinot
@spglobal.com

SECONDARY CONTACT

Elena Anankina, CFA
Moscow
+ 7 49 5783 4130
elena.anankina
@spglobal.com

Rating Action Overview

- On Oct. 13, Latvian electricity transmission system operator (TSO) Augstsprieguma Tikls (AST) issued a €100 million bond to refinance the €116.2 million bridge loan due on Dec. 18, 2021. As a result, all debt from the merger with Latvijas elektriskie t#kli (LET) has been repaid ahead of schedule, and AST has no large maturities in the next 5.25 years.
- After AST used part of the large extraordinary dividends from its gas business Conexus Baltic Grid (CBG)to reduce debt, the company has built some headroom in its financial metrics, and we now anticipate funds from operations (FFO) to debt to stabilize around 25%-35% over 2022-2023 and above 23% afterwards.
- We continue to see a high likelihood that the Latvian government (A+/Stable) will step in to support AST in times of distress.
- We are therefore raising our rating on AST to 'A-' from 'BBB+'.
- The stable outlook reflects our assumption that AST will continue to proactively manage its liquidity and maintain its FFO to debt above 23%.

Rating Action Rationale

The recent €100 million bond issuance fully refinances the remaining debt from the 2019 merger and improves liquidity. Following the extraordinary dividends from Conexus Baltic Grid (CBG) of €58.3 million in the first half of 2021, combined with the €100 million bond issuance in October, we note that the merger debt from LET's integration into AST has been fully repaid and refinanced. This leaves AST with only a €100 million bond due in January 2027 in its capital structure as of November 2021. As a result, we see AST's liquidity improving, with sources covering uses by more than 1.1x over the next 12 months and no meaningful maturities in the next several years. Our liquidity assessment is further underpinned by the company's aim to issue an additional €60 million as part of the €160 million green bond program combined with EU funds that could cover up to 75% of annual investments. We also factor in our liquidity assessment that AST is unlikely to breach its covenant, as well as its sound relationships with banks and good standing in the market, as the oversubscription of the recently issued bond showed.

We now expect AST's FFO to debt to be about 25%-34% in 2022-2023, weakening towards 23% upon higher capital expenditure (capex). AST has received a large €58m extraordinary dividend from CBG, the Latvian gas TSO of which AST owns 68.46%, and has used the dividend to deleverage ahead of schedule. This, together with the bond issuance, enabled AST to fully repay or refinance €225 million of legacy financial liabilities following the integration of LET in 2020. We now expect AST's S&P Global Ratings-adjusted net debt to reach the minimum of €80 million in 2021. We also expect our adjusted EBITDA to be stable at around €42 million-€44 million annually, including about €4 amillion annual dividends from CBG, leading to a temporary hike in financial metrics.

However, the upcoming large capital expenditure program amounting to €215 million over the next three years will pressure metrics and increase adjusted net debt toward €200 million by 2024. We expect capex to be partially debt-financed and EU funded, though we do not include EU funds in our base case, which could lead to some volatility in our metrics. We also understand that capex funded with EU grants won't form part of the regulatory asset base (RAB) and generate future return for AST.

We therefore now forecast AST's FFO to debt to be around 25%-34% over the next two years and to decrease towards 23% afterward, which we view as commensurate with AST's 'bbb' stand-alone credit profile.

The lack of track record of the Latvian electricity regulatory framework and the upcoming regulatory reset constrains our rating. We believe Latvia's new regulatory framework for power networks, established from January 2021, is credit-supportive. The new framework follows a revenue cap RAB methodology that provides more transparency and predictability than the previous framework, which followed a cost-plus method. Allowed revenues are now calculated based on the installed capacity in Latvia, allowed and justified costs, and AST's RAB, as well as the regulatory weighted-average cost of capital (WACC):

- AST's RAB is estimated at around €414 million. Despite large ongoing investments, investments financed by EU funds or by congestion income do not increase the RAB. We therefore expect the RAB to increase slowly because every future investment made with EU funding will be co-financed by AST.
- The WACC has decreased to 2.65% in 2021 from 3.3% in 2020. The WACC is calculated annually and is applied to the tariff upon request from the network; otherwise, it is expected to remain stable at 2.65%.
- 80% of the allowed revenues are fixed and based on Latvian installed capacity, with only 20% based on actual volumes transmitted through the Latvian network.

Our view of the lack of track record, the upcoming regulatory reset in January 2023, the lack of RAB build-up, and the exposure to 20% volume risks weigh on our assessment of the regulatory framework. We view the Latvian framework as strong/adequate, though at the weaker end of the range for that assessment under our criteria.

We view Conexus Baltic group (CBG) as an insulated part of the AST Group, and therefore adjust metrics as if it was an equity affiliate. CBG is the sole Latvian gas TSO, 68.46% owned by AST and ultimately by the Latvian government. Though it is majority-owned by AST, we believe it is insulated from the rest of the group for the following main reasons:

- Day-to-day operations, financial reporting, and cash management are separated between the two networks.
- CBG is regulated and we believe that ultimate decision-making on CBG strategy rests collectively with its government and private investor shareholders, and is executed through AST's and CBG's strategic goals and governance directions.
- CBG has a significant minority shareholder (MM Infrastructure Investments Europe Ltd.) with two members part of the recently created supervisory council, which has the final decision on all topics CBG-related.
- AST appointed four members of the current supervisory council, itself composed of seven members. Of the four members, one is an AST employee, one is from the ministry of finance, and two are independent.
- AST's dividends to the government are calculated on AST's pretax net income including dividends from CBG, not on a consolidated basis.

Although CBG is consolidated under AST's IFRS reports and therefore falls under cross-default under AST's bonds, we believe that CBG is a profitable business with currently limited debt and therefore is very unlikely to need any support from AST.

We treat CBG as an insulated business akin to an equity investee. In our EBITDA projection for AST, we do not consolidate CBG but rather include dividends from CBG to AST (we expect a dividend of €4 million in 2021 and similar amounts over the longer term, on a normalized basis).

Outlook

The stable outlook mirrors that on Latvia and considers our forecast of predictable cash flows from AST's regulated transmission activities, with FFO to debt declining from unusually high 115%-120% in 2021 to between 25%-35% over the medium term due to the high capex program.

Downside scenario

We see prospects of a downgrade as limited over the next two years as it would stem from FFO to debt falling below 23% without recovery prospects.

A one-notch downgrade of the sovereign would not trigger an automatic downgrade.

Upside scenario

We see prospects for an upgrade as remote given the company's small size and the short track records of its operations and of the current regulatory regime. Longer term, it would require FFO to debt above 35% coupled with:

- A track record of regulatory framework providing for cost-recovery;
- Strong build-up of the RAB supporting the regulated revenues;
- More clarity on financial policy; and
- The company's commitment to the higher rating.

A one-notch upgrade of the sovereign would not trigger an upgrade of AST.

Company Description

AST is the only electricity TSO in Latvia. Established in 1939 and fully owned by the Ministry of Finance, the AST group is now composed of the electricity TSO and 68.46% of the gas TSO (Conexus Baltic Grid).

AST owns 5,424km of power lines and 140 substations. AST transmits approximately 6 terawatt hours of electricity throughout Latvia and neighboring countries including Estonia, Lithuania, Russia, and Belarus through seven interconnections (two with Estonia, four with Lithuania, and one with Russia). By 2025, AST aims to have synchronized with Europe and disconnected Latvia from the Russian power system.

Our Base-Case Scenario

Assumptions

- The regulatory framework started in 2021 with the first period lasting two years; the subsequent periods will be five years, from January 2023.
- Close to no revenue growth over the forecast period based on a predictable and stable new regulatory framework, for which allowed revenues are computed for the entire period.
- 80% of allowed revenues fixed and based on Latvian power generation capacity. We expect it to remain stable as Latvia's aim is to synchronize with Central Europe through increased connection between Latvia and Poland, while disconnecting from Russia.
- WACC of 2.65% from 2021 (from 3.31% in 2020) with the possibility of being reassessed upon the network's request to change tariffs during regulatory periods.
- Stable reported EBITDA at around €42 million-€44 million over the next two regulatory periods (seven years).
- Exclusion of congestion income from revenues (about 4% revenues) and EBITDA (about 8% EBITDA) but included in operating cash flows.
- Investments in line with the board- and regulator-approved 10-year investment plan. In our base case, we don't forecast EU funds to support these investments.
- Change in dividend policy from a 60% payout ratio (excluding corporate income tax [CIT]; 80% including CIT) to a 65% dividend payout ratio (excluding CIT; 85% including CIT) from 2023 onward. The dividend calculation is based on the previous year's net income including the dividend received from Conexus Baltic Grid.
- Interest rate of 0.5% on the newly issued bond maturing in January 2027 used to repay the remaining liabilities from the LET merger, resulting in AST's capital structure comprising only the €100 million bond.

Key metrics

	--Fiscal year ending Dec. 31--			
(Mil. €)	2020a	2021f**	2022f	2023f
EBITDA	46.9	95-100	40-45	40-45
Funds from operations (FFO)	46.6	90-95	35-40	35-40
Capital expenditures	13.0	25-30	50-55	80-85
Dividends	1.4	5-10	25-30	5-10
Debt	162.2	75-80	110-120	155-165
Debt to EBITDA (x)	3.5	0.5-1.0	3.5-3.0	3.5-4.0
FFO to debt (%)	28.7	115-120	30-35	23-25

*All figures adjusted by S&P Global Ratings. **Includes one-off dividends from CBG of €58.3 million. a--Actual. f--Forecast.

Liquidity

We assess AST's liquidity as adequate because we now expect liquidity sources to cover uses by more than 1.1x over the 12 months starting Oct. 30, 2021. The adequate liquidity is further underpinned by AST's good relationship with banks as demonstrated by its ability to successfully contract bank loans and overdraft facilities at a good price. AST's good standing in the credit market was also demonstrated following the recent bond issuance of €100 million for 5.25 years at 0.5%.

Principal liquidity sources include as of Oct. 30, 2021:

- Cash and cash equivalents of about €13.3 million;
- Operating cash flows of about €60 million over the next 12 months;
- A €20 million undrawn facility maturing in June 2023 to be used to finance working capital swings; and
- Annual working capital inflow from congestion income of around €4 million.

Principal liquidity uses include over the same period:

- About €43 million of capital expenditures;
- Dividends of about €29 million; and
- No debt maturity until 2027.

Covenants

AST has significant headroom under the three covenants from its overdraft facility maturing in 2023:

- Debt service coverage ratio greater than 1.2x;
- Equity greater than 25%; and
- Debt to EBITDA less than 6x.

Issue Ratings - Subordination Risk Analysis

Capital structure

AST's capital structure now only comprises one €100 million bond maturing in January 2027.

Analytical conclusions

We do not apply any notching to the €100 million bond and therefore rate it in line with the credit rating on AST at 'A-'.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/--

Business risk: Strong

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Adequate
- Management and governance: Fair
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb

- Related government rating: A+/Stable
- Likelihood of government support: 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

- Latvian TSO Augstsprieguma Tikls Rated 'BBB+'; Outlook Stable, Feb. 16, 2021
- Latvian TSO Augstsprieguma Tikls Ratings Affirmed At 'BBB+'; Outlook Revised To Positive On Lower Country Risk, Aug. 12, 2021

Ratings List

Upgraded; Outlook Action

	To	From
Augstsprieguma Tikls		
Issuer Credit Rating	A-/Stable/--	BBB+/Positive/--
New Rating		
Senior Unsecured	A-	