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RATING ACTION COMMENTARY

Fitch Revises Enerjisa's Outlook to Negative; Affirms at 'AA+(tur)'

Fri 16 Dec, 2022 - 11:34 AM ET

Fitch Ratings - Dubai - 16 Dec 2022: Fitch Ratings has revised Enerjisa Enerji A.S.'s (Enerjisa) Outlook to Negative from Stable and affirmed its National Long-Term Rating at 'AA+(tur)'.

The Negative Outlook reflects the large working-capital outflow in Enerjisa's supply segment in 2022 resulting from mismatch of supply-tariff indexation and electricity purchase prices. It led to weakened cash flow generation and worsening liquidity in 9M22. The compensatory mechanisms from the Turkish regulator aimed at reducing energy procurement costs and supporting electricity suppliers have been insufficient to reverse the negative trend to date. The Negative Outlook also reflects tougher refinancing terms for Enerjisa due to high inflation and slowing growth in Turkiye.

We may revise the Outlook to Stable once we see evidence of the regulatory measures and management efforts reversing the negative trends in working capital and improving Enerjisa's liquidity. Enerjisa's rating remains constrained by the liquidity risk related to its short-term debt maturity profile and reliance on continued access to domestic bank funding, mostly on an uncommitted basis.

KEY RATING DRIVERS

Working-Capital Outflow: Fitch-calculated cash flow from operations decreased to TRY0.8 billion in 9M22 from TRY2.7 billion in 9M21. This was a result of working-capital outflow of TRY7 billion in 9M22 as residential and commercial tariff increases were not sufficient to cover electricity procurement prices, which rose 162% over FY22 (year-end September). As the regulatory framework allows a 2.38% margin in the regulated retail segment over electricity procurement cost, both of which Enerjisa accrues as revenue. The difference between actual and future supply tariffs is reflected as working-capital outflow.

Liquidity Pressure Rising: Fitch-calculated debt increased to TRY16.4 billion at end-3Q22, including short-term debt of around TRY12 billion, up from TRY11 billion at end-2021, as Enerjisa was attracting short-term loans to finance negative free cash flow (FCF). We expect Enerjisa to refinance short-term debt at tougher terms, based on Fitch-projected inflation in Turkiye of 73% in 2022 and 59% in 2023 versus 19% in 2021. Its cost of bank funding has grown to around 32% in 3Q22 from 14% in 3Q21. This is partially balanced by uninterrupted access to funding and the successful placement of TRY3 billion of local bonds in October 2022 maturing in one-to-two years.

Regulatory Support Measures: The Turkish regulator has implemented measures to limit energy-cost increases to suppliers. These include a price cap for renewable producers from 2Q22, with the difference between the market price and the price cap to be collected in a pool to reduce the cost of regulated procurement cost for retail companies. Further, the government-owned electricity generation company EUAS started to sell electricity to retail companies at below-market prices since August 2022. In addition, an energy exchange company EPIAS has granted retail companies the option to defer payments in the regulated segment from July 2022.

Those measures started to take effect in 3Q22, but have not fully compensated Enerjisa's negative FCF from 1H22. Enerjisa anticipates a more significant positive impact in 4Q22 and in the beginning of 2023.

Challenging Year Ahead: In our view, the positive impact of regulatory measures should be more pronounced in 4Q22 and support Enerjisa's cash flow generation. However, we believe 2023 may be another challenging year for the company's supply business if high energy prices persist. This is because the government may want to limit the impact of high energy prices on end-customers and continue restricting tariffs.

Stable Distribution Business: Enerjisa's electricity distribution continues to be fairly transparent and stable and therefore supportive of ratings. Distribution fees increased 24% from January 2022 and by a further 2% from April 2022. The key parameters set for the fourth regulatory period of 2021-2025, such as regulatory asset base (RAB) methodology, real weighted average cost of capital (WACC) of 12.3%, 10-year reimbursement period and efficiency incentives, remain and continue to support profitability.

Moderate Leverage, Weak Coverage: We forecast funds from operations (FFO) net leverage on average close to 2x over 2022-2025. This is backed by healthy EBITDA on average of around TRY16 billion over 2022-2025, which is driven by financial income and capex reimbursement, and income from efficiency incentives. However, we expect FCF to remain negative on working-capital outflow, capex and dividends. We also forecast FFO interest coverage to gradually decline towards 2x as Enerjisa refinances short-term debt at higher rates.

Low FX Risks: Enerjisa's debt is denominated in Turkish lira, which protects the company from risks of lira depreciation. We view the low foreign-exchange (FX) exposure as positive for the rating compared with many Turkish corporate peers.

DERIVATION SUMMARY

Compared with European networks, Enerjisa benefits from an attractive regulated rate of allowed return (real WACC of 12.3%) and a shorter principal payback period of 10 years. However, we consider electricity distribution companies in Turkiye as higher-risk, due to the lack of ownership of infrastructure assets and treatment of investments in the grid as financial assets.

Enerjisa is strong versus Turkish corporates due to reasonable earnings visibility, supportive regulation, lack of FX risks and proven access to domestic funding. Among the peers rated on a national scale, Arcelik A.S. (AAA(tur)/Stable), a white goods producer, benefits from exposure to international markets and FX-linked revenue. Migros Tiracet A.S. (AAA(tur)/Stable), a leading food retailer, has positive FCF through the cycle and good liquidity. Turk Telekomunicasyon A.S. (AAA(tur)/Stable), an incumbent fixed-line operator, benefits from large scale of operations and a strong financial profile.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer are as follows:

- Real returns on RAB in the regulatory period 2021-2025 at 12.3%

- Inflation of 73% in 2022, 59% in 2023 and 51% in 2024

- Annual capex on average at TRY12 billion over 2022-2024

- Dividends on average of TRY3.3 billion annually over 2023-2025

- Regulated gross profit margins for regulated customers at 6%-7% to 2025

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Due to the Negative Outlook, an upgrade is currently unlikely. However, evidence of working-capital improvement and reduction in the absolute amount and share of short-term debt could lead to the Outlook being revised to Stable

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Continued working-capital outflow in the supply segment leading to an accelerated increase in volumes of short-term debt

- Evidence of weaker access to bank and bond-market funding

- FFO net leverage above 4.0x and FFO interest coverage below 2.0x, both on a sustained basis

- Adverse regulation effects including delays in recoveries of investments

- Large unhedged foreign-currency debt exposure

LIQUIDITY AND DEBT STRUCTURE

We continue to view liquidity and debt management as rating constraints. At end-3Q22, available cash of around TRY1.7 billion and an available credit line from EBRD of TRY2 billion were insufficient to cover short-term debt of TRY12 billion and Fitch-expected negative FCF 12 months ahead. In October 2022, Enerjisa issued bonds of TRY3 billion with a one-and two-year maturity. To fund the liquidity gap, Enerjisa plans to issue another bond on the Turkish bond market and continue using credit lines with Turkish banks on an uncommitted basis, in line with the Turkish market practice.

We expect that the tariff deficit in the supply segment, if not fully addressed by the regulatory support measures, may increase liquidity risk and lead to higher external financing needs, currently not covered by Enerjisa's available funding sources.

ISSUER PROFILE

Enerjisa is a large electricity distribution and supply company in Turkiye with around a 25% market share in distribution and 22% in electricity supply. Enerjisa operates through its three subsidiaries: Ayedas on the Asian side of Istanbul, Baskent in the Ankara region and Toroslar in the southern part of Turkiye in Adana and Gaziantep. Enerjisa is owned by E.ON (40%), and Sabanci Holdings (40%) and has 20% free float since its IPO in 2018.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-calculated EBITDA and FFO includes cash-effective capex and WACC reimbursements related to service concession arrangements.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT ⇕	RATING ⇕	PRIOR ⇕

Enerjisa Enerji A.S.	Natl LT	AA+(tur) Rating Outlook Negative	Affirmed	AA+(tur) Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Enerjisa Enerji A.S.	-

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