Fitch Affirms Enerjisa and Baskent at 'AA(tur)'; Outlooks Stable

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Fitch Ratings - Warsaw - 17 January 2020:

Fitch Ratings has affirmed the National Long-Term Ratings of Turkish utilities company Enerjisa Enerji A.S. and one of its main electricity distribution subsidiaries, Baskent Elektrik Dagitim A.S. at 'AA(tur)' with Stable Outlooks.

Enerjisa's and Baskent's ratings reflect predictable regulated earnings, with 13.6% real returns on the regulatory asset base (RAB), indexed for inflation. Both companies will enter a new five-year regulatory period in 2021. In our projections we assume no major changes in the regulatory parameters compared with the current regulatory period (2016-2020). Based on its Parent And Subsidiary Rating Linkage Criteria, Fitch rates Enerjisa and Baskent on a consolidated basis, and as a result rates both companies at the same level.

KEY RATING DRIVERS

Healthy Performance: Enerjisa performed well in 9M19 against a backdrop of a difficult macroeconomic environment in Turkey. Operational earnings grew by 27% to TRY3.5 billion, mainly due to increased financial income from service concession arrangements and higher capex reimbursements as the regulatory asset base continues to grow and exceeded TRY8 billion in 2019.

Stronger cash flows from operating activities in 9M19 enabled the company to improve free cash flow (FCF) generation (after interest and dividends) despite interest paid almost doubling to TRY1.5 billion in this period due to higher market interest rates and borrowing costs.

Regulated Distribution: Electricity distribution remains Enerjisa's main business segment in terms of operational earnings (almost 90% in 9M19), with the remainder generated by the retail business. However, retail is less capital intensive than distribution, and as a result it generates better FCF than distribution and its share of net income is higher than of operational earnings.

Returns Driven by Investments: Most of Enerjisa's operational earnings in distribution comes from distribution return allowed on investments and capex reimbursements but also incentives and outperformance of regulatory targets. It is unclear at what return level the regulator will remunerate maintenance and repair capex once capex requirements slow. However, the Turkish distribution infrastructure needs investment and the high investment cycle is likely to continue well into the current decade.

Prudent Approach to Leverage: Enerjisa's financial policy for 2016-2020 assumes maintenance of leverage below 3.5x net debt-to- operational earnings. This ratio improved to 2.3x in 2018 from 2.8x in 2017. The company projects that leverage will not exceed 2x in 2020. We view positively Enerjisa's successful efforts to reduce leverage in a period of increased economic uncertainty and slower growth in Turkey. We project both companies to continue reducing funds from operations (FFO) adjusted net leverage in 2019-2021.

Low Interest Coverage: FFO fixed charge cover is low compared with international peers, partly due to an increase in borrowing costs in Turkey in 2018-1H19 affecting the cost of bank loans. Positively, borrowing costs in Turkish lira have decreased since May 2019 to the pre-crisis level. This should enhance the interest coverage ratio as the company refinances its more expensive bank loans. About 15% of Enerjisa's debt at end-September 2019 were CPI-linked domestic bonds for which interest rate is effectively hedged as the company's tariffs and remunerations are adjusted for inflation.

Limited Forex Risk: The vast majority of Enerjisa's debt is denominated in Turkish lira with the remainder of about 4% mostly legacy EIB and World Bank loans, for which the exposure is hedged. We view the limited forex exposure as positive for the rating compared with corporate peers in Turkey.

Structural Subordination: Despite the consolidated approach to Enerjisa's rating, we view its creditors as structurally subordinated to the creditors of the group's subsidiaries. This would be reflected in our recovery assumptions and any instrument rating. This assessment is in line with Fitch's view that when there are multiple operating entities, Fitch evaluates the claims at the entity level and views only residual cash flows as being available to the parent's creditors.

DERIVATION SUMMARY

Compared with other regulated peers, Baskent and Enerjisa benefit from an attractive regulated rate of allowed return (real WACC of 13.6%) and a shorter principal payback period of 10 years. However, compared with other European networks we consider electricity distribution companies in Turkey to be riskier, due to the fact that the companies do not own the infrastructure assets and investments in the grid are treated as financial assets. In the context of Turkish peers, we assess Baskent and Enerjisa as relatively strong due to solid earnings visibility, limited forex exposure and the well diversified liquidity lines.

Based on the Parent and Subsidiary Rating Linkage Criteria Fitch rates Enerjisa and Baskent on a consolidated basis given moderate to strong operational and legal ties between both companies. As a result, we rate both companies at the same level.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for Enerjisa and Baskent

- Returns on RAB in the new regulatory period starting in 2021 unchanged at 13.6%

- Capex spending assumed in line with management's expectations, with investments of about TRY9.1 billion for Enerjisa (consolidated) and about TRY3.8 billion for Baskent between 2019 and 2022

- Dividends in line with management's expectations

RATING SENSITIVITIES

Enerjisa

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- FFO adjusted net leverage below 3.0x and FFO fixed charge cover above 3.0x, both on a sustained basis

- Better clarity on regulation after high-intensity investment ends

- Improvement in liquidity position and debt maturity profile.

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 4.0x and FFO fixed charge cover below 2.0x, both on a sustained basis

- Any adverse regulation effects including delays in recoveries of investments.

- Adverse developments in the process of the retail market liberalisation

- Deterioration in available liquidity

- Large unhedged foreign currency debt exposure

Baskent

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- FFO adjusted net leverage below 3.0x and FFO fixed charge cover above 3.0x, both on a sustained basis

- Better clarity on regulation after the capital-intensive investment ends

- Improvement in liquidity position and debt maturity profile

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 4.0x and FFO fixed charge cover below 2.0x, both on a sustained basis

- Adverse regulation effects including delays in recoveries of investments

- Weakening of available liquidity

- Large unhedged foreign currency debt exposure

LIQUIDITY AND DEBT STRUCTURE

We view liquidity and debt management as rating constraints. Enerjisa and Baskent maintain low levels of readily available cash compared with short-term debt. For instance, at end-September 2019 Enerjisa (consolidated) had readily available cash of TRY0.2 billion versus total short-term financial liabilities of TRY4.4 billion. At this date, the company had available bank facilities of TRY11.8 billion on an uncommitted basis, mainly from Turkish banks, and no committed lines. As a result, the company's liquidity is reliant on continued access to bank funding largely on an uncommitted basis, in line with the Turkish market practice, and FCF generation.

The liquidity risk is mitigated by Enerjisa's and Baskent's record of uninterrupted access to bank funding even at times of a macroeconomic stress due to the companies' profiles and operations in a predictable, regulated business. In 4Q19, Enerjisa signed committed facilities for TRY1.9 billion, improving its liquidity position.

SUMMARY OF FINANCIAL ADJUSTMENTS

The impact of derivatives hedging foreign-currency debt is reflected in Fitch-adjusted debt.

Bank deposits blocked at different banks (for 1-2 days) treated as not readily available cash.

Capitalisation of operating leases using a 5x multiple, applicable for Turkey. Fitch's projections for 2019-2023 exclude the impact of IFRS 16.

In addition, for Baskent adjusted debt includes inter-company loans from Enerjisa.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

RATING ACTIONS

Baskent Elektrik Dagitim A.S.

Natl LTAA(tur) Affirmed	AA(tur)

Enerjisa Enerji A.S.

Natl LTAA(tur) Affirmed	AA(tur)

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Corporate Rating Criteria (pub. 19 Feb 2019)

Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

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