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## Fitch Upgrades Enerjisa and Baskent to 'AA+(tur)'; Outlooks Stable

Fitch Ratings - Warsaw - 18 Feb 2021: Fitch Ratings has upgraded 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. to 'AA+(tur)' from 'AA(tur)'. The Outlooks on both ratings are Stable.

The upgrades reflect the new regulatory period (2021-2025), which includes a full reimbursement of investments over 10 years at a real rate of return of 12.3%, and higher capex allowances that we expect to substantially reduce cash flow volatility due to the lag of regulated earnings cash recognition. We forecast funds from operations (FFO) net leverage to decrease slightly below 2.0x in 2021-2023 from 2.4x at the end-2019 reflecting a higher asset base and additional income from efficiency incentives. This leverage remains below the 3.0x negative sensitivity for the AA+(tur) rating.

The ratings are constrained at the current level due to exclusively domestic operations, liquidity risk related to relatively short-term debt maturity profile and reliance on continued access to domestic bank funding largely on an uncommitted basis.

Based on the 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

**Supportive Fourth Regulatory Period:** Fitch continues to evaluate Turkish electricity distribution regulation as fairly transparent and stable and therefore supportive of Enerjisa's rating. The key parameters set for the new regulatory period (2021-2025), such as return on regulated asset base (RAB) methodology, 10-year reimbursement period and efficiency incentives, remain in place and will continue to drive the company's profitability. We expect a higher RAB, built up by a substantial increase in the initial capex allowances, to compensate for a lower real rate of return (set at 12.3% versus 13.6% in the previous regulatory period).

**More Challenging Efficiency Targets:** The fourth regulatory period update from the Energy Market Authority (EMRA) remains investment-orientated but increasingly promotes quality of supply, in-house sourcing, customer satisfaction, transparency governance and sustainability. These include a reward/penalty mechanism for quality parameters and tighter theft and loss targets and reduced theft usage accrual rates. To maintain current revenue levels in these areas, the company may require additional improvements, which will be achieved through increased capex and opex allowances.

On the other hand, the new incentives (in-house sourcing and incentives for publicly listed companies) that Enerjisa would be eligible for would be important factors mitigating these risks. We view Enerjisa as well positioned in achieving the bonuses due to a history of strong performance and do not expect any substantial negative impact from the stricter guidelines.

**Lower Leverage, Negative Cash Flows:** We forecast FFO net leverage to decrease slightly below 2x in 2021-2023, compared with 2.5x expected in 2020, providing comfortable headroom against our negative rating sensitivity of 3x. This is driven by strong growth in the RAB, which we expect to be around TRY11 billion in 2021 and reimbursement related to previous years, including capex overinvestment from the previous regulatory period. This is expected to result in TRY1.5 billion of cash inflows per year in 2021 and 2022.

Adequate rating headroom for net leverage could mitigate the volatility of FFO interest coverage if market interest rates are higher. Our rating case for Enerjisa forecasts negative free cash flow after interest and dividends (FCF) through the rating horizon (2020-2024). This is largely due to the combined effect of higher expected capex and an unchanged dividend policy of 60% of consolidated underlying net income.

**Limited Coronavirus Impact:** As a regulated essential services provider, Enerjisa has been fairly resilient to the impact of the Covid-19 pandemic, due its high share of regulated EBITDA in distribution and retail (around 95% at end-December 2019) which is RAB-based and has no link to consumption volumes. There have been some temporary impacts on cash flows arising from under-invoiced collection for distribution. However, this is recovered with a two-year lag, and one quarter lag for regulated supply.

We expect limited volume impact on cash flows in 2020, as 9M20 distribution volumes remained flat and sales volume reduction due to reduced demand among regulated customers should have already been recovered in 2020.

**Previous Revenue Cash Settlement:** We expect additional cash inflows of TRY1.5 billion a year in 2021 and 2022 from the reimbursement related previous regulatory periods. In the third regulatory period, Enerjisa's actual capex allowance was 43% higher than initially granted, and the supplementary investments were not remunerated on the cash basis until the beginning of the new regulatory period in 2021. We assume higher capex allowances to substantially reduce cash flow volatility due to the lag of regulated earnings cash recognition.

**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 is reflected in our recovery assumptions and instrument ratings. 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 weighted average cost of capital (WACC) of 12.3%) and a shorter principal payback period of 10 years. However, compared with other European networks, we consider electricity distribution companies in Turkey 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 strong access to domestic bank funding.

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

### Enerjisa

- Returns on RAB in the new regulatory period starting in 2021 at 12.3%, down from 13.6% in 2020
- Inflation of around 10% on average in 2020-2024.
- Capex assumed in line with management's expectation for 2020, and, for the period between 2021 and 2024, management plans to meet at least the capex ceiling granted by the fourth regulatory period tariff.
- Dividends with pay-out at 60% of previous year consolidated underlying net income
- Regulated gross profit margins for regulated customers at around 6%-7%
- Cash reimbursement related to the previous regulatory period of TRY1.5 billion a year in 2021 and 2022

### Baskent

- Returns on RAB in the new regulatory period starting in 2021 at 12.3%, down from 13.6% in 2020
- Inflation of around 10% on average in 2020-2024.
- Capex assumed in line with management's expectation for 2020, and, for the period between 2021 and 2024, management plans to meet at least the capex ceiling granted by the fourth regulatory period tariff.
- Dividends in line with historical practices
- Cash reimbursement related to the previous regulatory period of TRY0.5 billion a year in 2021 and 2022

## **RATING SENSITIVITIES**

### **Enerjisa**

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

We do not anticipate positive rating action due to the entirely domestic operations, liquidity risk related to relatively short-term debt maturity profile and reliance on continued access to domestic bank funding largely on an uncommitted basis. However, an improvement in the liquidity position and debt maturity profile could lead to positive rating action.

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

- FFO net leverage above 3.0x and FFO interest coverage below 3.0x, 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**

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

We do not anticipate positive rating action due to the entirely domestic operations, liquidity risk related to relatively short-term debt maturity profile and reliance on continued access to domestic bank funding largely on an uncommitted basis. However, an improvement in the liquidity position and debt maturity profile could lead to positive rating action.

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

- FFO net leverage above 3.0x and FFO interest coverage below 3.0x, 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. At end-September 2020 Enerjisa

(consolidated) had readily available cash of TRY0.5 billion versus short-term debt of TRY3.4 billion. The company also had an available committed European Bank for Reconstruction and Development (EBRD) loan of TRY0.9 billion (USD100 million). The liquidity profile improved with an additional USD125 million EBRD loan agreement signed in May 2020 of which USD75 million was utilised in February 2021, and USD50 million is available until June 2021.

The majority of funding is available for both companies on an uncommitted basis (TRY5.7 billion at end-September for Enerjisa and TRY1.3 billion for Baskent) in line with Turkish market practice. The debt maturity profile remains relatively short-term in nature, reflecting the limited availability of long-term funding from domestic banks. This is common among Turkish corporates but exposes the company to systemic liquidity risk. 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.

Geographical diversification of debt sources together with reduced reliance on short-term funding could be credit positive.

## **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.

Fitch EBITDA and FFO includes cash effective capital expenditures and WACC reimbursements related to service concession arrangements.

Lease liabilities are deducted from debt and lease costs are part of opex.

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

## **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.

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**Rating Actions**

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Baskent Elektrik Dagitim A.S.	Natl LT	AA+(tur) 	Upgrade	AA(tur) 
Enerjisa Enerji A.S.	Natl LT	AA+(tur) 	Upgrade	AA(tur) 

**RATINGS KEY OUTLOOK WATCH**

POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

**Applicable Criteria**[Corporate Rating Criteria \(pub.21 Dec 2020\) \(including rating assumption sensitivity\)](#)[National Scale Rating Criteria \(pub.22 Dec 2020\)](#)[Parent and Subsidiary Linkage Rating Criteria \(pub.26 Aug 2020\)](#)

## Applicable Models

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 [\(1\)](#)

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