

Tear Sheet:

Conexus Baltic Grid

August 1, 2023

The new regulatory period for gas transmission should be credit neutral for Conexus Baltic Grid (Conexus). To compensate for reduced gas consumption by approximately 30% in 2022 and 8% in the first quarter of 2023, Conexus has submitted a proposal for a 39% tariff increase over the new three-year regulatory period, starting in October 2023. The proposed increase should not materially affect end users' bills. S&P Global Ratings continues to expect the transmission segment to report annual revenue of €40 million-€45 million.

While increasing demand for gas storage has led to higher revenue, current regulations require a review. Conexus underground gas storage (UGS) has been fully booked over the past two years at a higher rate than that set by the regulator, with a €1.62 per megawatt hour (/MWh) premium earned against the 22.6 terawatt hour (TWh) capacity booked. That led to extraordinary revenue of €28.3 million in 2023, and expected revenue of €10 million-€15 million by year-end 2024. The increase in revenue could lead to a large downward revision by the regulator on tariffs for storage activities over the next three years.

Higher investment requirements and an aggressive dividend policy limit Conexus' rating headroom. To maintain and increase capacity at the UGS, Conexus plans to invest up to €100 million-€120 million over 2023-2027 which, combined with the 90% dividend payout, is expected to lead to negative discretionary cash flows (DCF) of about €20 million-€30 million over the next three years. However, we anticipate that funds from operations (FFO) to debt will remain stable albeit slightly below our threshold of 18% for the current rating. We expect Conexus to continue complying with its covenant of maintaining net debt to EBITDA below 5x over the forecast period.

Conexus' proposed listing could potentially weaken the link with its parent, Augstsprieguma Tikls (AST). In May 2023, the Latvian government announced its intentions for a partial initial public offering (IPO) for Conexus in the coming years, albeit while maintaining state control. Although we note that this might weaken the link with AST, we do not expect this to happen before 2025. As soon as we see tangible signals of a potential IPO, we will update our base case.

Primary contact

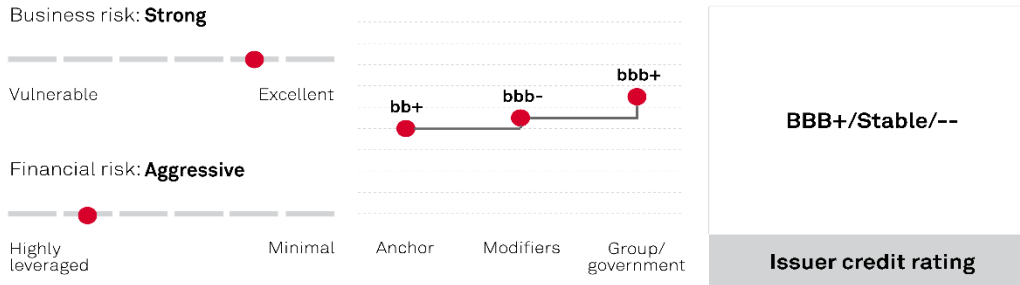
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Ratings Score Snapshot

Conexus Baltic Grid



Recent Research

- Industry Top Trends Update Europe: Utilities, July 18, 2023
- Europe's Utilities Face A Power Price Cliff From 2026, June 22, 2023
- Eastern European Utilities 2023 Outlook Published, Jan. 13, 2023
- Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive, Nov. 30, 2022

Company Description

Conexus is the natural gas transmission and storage operator in Latvia. Its operations are split evenly between transmission and storage activities.

- The 1,190-kilometer-long gas transmission network directly connects Latvia with Lithuania, Estonia, and Russia. Since April 2022, no Russian gas has been used in the Baltics, although it transits through the network enroute to Kaliningrad.
- Inčukalns is the sole underground gas storage in the region, with a gas capacity of 46 TWh, or 2.3 billion cubic meters, of which 22 TWh is considered cushion gas.

Established in 2017 following the unbundling of the Latvian energy sector, Conexus is now 68.46%-owned by AST (the electricity transmission system operator itself is 100%-owned by the state of Latvia) and 29.06%-owned by MM Infrastructure Europe, an infrastructure fund headquartered in Japan.

Outlook

The stable outlook reflects that on the parent, AST. Moreover, it is based on our expectation that Conexus will maintain FFO to debt of 18%-23% while keeping its debt to EBITDA below 5x.

Downside scenario

We could take a negative rating action if one or a combination of the following elements occur:

- Conexus' importance in the AST group weakens.
- We downgrade AST.
- Conexus' FFO to debt falls below 18% or debt to EBITDA exceeds 5x.

Upside scenario

We could take a positive rating action on Conexus if we upgrade AST to 'A' from 'A-'. We could revise up our assessment of Conexus' stand-alone creditworthiness to 'bbb' from 'bbb-', if its FFO to debt remained well above 23%, with debt to EBITDA below 3.5x on a stand-alone basis, although this would not have any positive impact on the final rating.

Key Metrics

JSC Conexus Baltic Grid--Forecast summary

| Period ending | Dec-31-2021 | Dec-31-2022 | Dec-31-2023 | Dec-31-2024 | Dec-31-2025 |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|
| (Mil. EUR) | 2021a | 2022a | 2023e | 2024f | 2025f |
| Revenue | 56 | 55 | 50-60 | 60-70 | 60-70 |
| EBITDA | 33 | 32 | 25-30 | 25-30 | 25-30 |
| Funds from operations (FFO) | 31 | 29 | 20-25 | 20-25 | 20-25 |
| Capital expenditure (capex) | 28 | 18 | 40-45 | 40-45 | 40-45 |
| Dividends | 84 | 10 | 5-10 | 0-5 | 0-5 |
| Debt | 101 | 89 | 100-150 | 100-150 | 100-150 |
| Adjusted ratios | | | | | |
| Debt/EBITDA (x) | 3.1 | 2.8 | 4.0-4.5 | 4.0-4.5 | 4.5-5.0 |
| FFO/debt (%) | 30.3 | 33.0 | 17.5-18.0 | 18.0-18.5 | 15.0-16.5 |
| DCF/debt (%) | (83.5) | 4.9 | (30)-(20) | (20)-(10) | (15)-(5) |

Financial Summary

JSC Conexus Baltic Grid--Financial summary

| Period ending | Dec-31-2021 | Dec-31-2022 |
|-----------------------------|-------------|-------------|
| Reporting period | 2021a | 2022a |
| Display currency (mil.) | EUR | EUR |
| Revenues | 56 | 55 |
| EBITDA | 33 | 32 |
| Funds from operations (FFO) | 31 | 29 |
| Interest expense | 0 | 1 |
| Cash interest paid | 0 | 1 |
| Operating cash flow (OCF) | 28 | 32 |
| Capital expenditure | 28 | 18 |

JSC Conexus Baltic Grid--Financial summary

| | | |
|---------------------------------|--------|------|
| Free operating cash flow (FOCF) | 0 | 14 |
| Discretionary cash flow (DCF) | (84) | 4 |
| Cash and short-term investments | 15 | 11 |
| Gross available cash | 15 | 11 |
| Debt | 101 | 89 |
| Common equity | 332 | 333 |
| Adjusted ratios | | |
| EBITDA margin (%) | 58.7 | 58.7 |
| Return on capital (%) | 3.5 | 3.4 |
| EBITDA interest coverage (x) | 115.7 | 53.6 |
| FFO cash interest coverage (x) | 137.3 | 53.2 |
| Debt/EBITDA (x) | 3.1 | 2.8 |
| FFO/debt (%) | 30.3 | 33.0 |
| OCF/debt (%) | 27.4 | 35.5 |
| FOCF/debt (%) | 0.0 | 15.5 |
| DCF/debt (%) | (83.5) | 4.9 |

Peer Comparison

JSC Conexus Baltic Grid--Peer Comparisons

| | JSC Conexus Baltic Grid | Madrilea Red de Gas S.A.U. | Nortegas Energa Distribucion S.A.U. | Caribbean Utilities Co. Ltd. | Augstsprieguma Tiks |
|---------------------------------------|--------------------------------|-----------------------------------|--|-------------------------------------|----------------------------|
| Foreign currency issuer credit rating | BBB+/Stable/-- | BBB-/Stable/A-3 | BBB-/Stable/-- | BBB+/Stable/-- | A-/Stable/-- |
| Local currency issuer credit rating | BBB+/Stable/-- | BBB-/Stable/A-3 | BBB-/Stable/-- | BBB+/Stable/-- | A-/Stable/-- |
| Period | Annual | Annual | Annual | Annual | Annual |
| Period ending | 2022-12-31 | 2021-12-31 | 2022-12-31 | 2022-12-31 | 2022-12-31 |
| Mil. | EUR | EUR | EUR | EUR | EUR |
| Revenue | 55 | 184 | 217 | 250 | 303 |
| EBITDA | 32 | 139 | 154 | 67 | 47 |
| Funds from operations (FFO) | 29 | 107 | 121 | 54 | 47 |
| Interest | 1 | 29 | 18 | 14 | 1 |
| Cash interest paid | 1 | 26 | 18 | 12 | 0 |
| Operating cash flow (OCF) | 32 | 110 | 123 | 44 | 35 |
| Capital expenditure | 18 | 13 | 27 | 83 | 31 |
| Free operating cash flow (FOCF) | 14 | 97 | 96 | (38) | 4 |

JSC Conexus Baltic Grid--Peer Comparisons

| | | | | | |
|---------------------------------|------|------|-------|--------|--------|
| Discretionary cash flow (DCF) | 4 | 97 | 26 | (61) | (25) |
| Cash and short-term investments | 11 | 41 | 39 | 7 | 92 |
| Gross available cash | 11 | 41 | 39 | 7 | 92 |
| Debt | 89 | 920 | 1,100 | 331 | 26 |
| Equity | 333 | 433 | 992 | 288 | 448 |
| EBITDA margin (%) | 58.7 | 75.3 | 71.1 | 26.6 | 15.5 |
| Return on capital (%) | 3.4 | 9.2 | 3.3 | 5.8 | 2.3 |
| EBITDA interest coverage (x) | 53.6 | 4.8 | 8.8 | 4.9 | 70.5 |
| FFO cash interest coverage (x) | 53.2 | 5.1 | 7.6 | 5.5 | 203.5 |
| Debt/EBITDA (x) | 2.8 | 6.6 | 7.1 | 5.0 | 0.5 |
| FFO/debt (%) | 33.0 | 11.6 | 11.0 | 16.5 | 181.0 |
| OCF/debt (%) | 35.5 | 11.9 | 11.2 | 13.4 | 135.1 |
| FOCF/debt (%) | 15.5 | 10.5 | 8.7 | (11.6) | 15.3 |
| DCF/debt (%) | 4.9 | 10.5 | 2.4 | (18.5) | (97.5) |

Environmental, Social, And Governance

ESG Credit Indicators

| | | | | | | | | | | | | | | |
|----------------------------|-----|------------|-----|-----|-------|------------|-----|-----|-----|-------|------------|-----|-----|-----|
| E-1 | E-2 | E-3 | E-4 | E-5 | S-1 | S-2 | S-3 | S-4 | S-5 | G-1 | G-2 | G-3 | G-4 | G-5 |
| - Climate transition risk. | | | | | - N/A | | | | | - N/A | | | | |

N/A--Not Applicable. ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumeric 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicator Definitions And Applications," published Oct. 13, 2021.

Environmental factors are a moderately negative consideration in our credit analysis of Conexus. Similar to other gas utilities, we view the company's exposure to gas as moderately negative, considering recent geopolitical developments in Ukraine and European pressure to reduce dependence on gas. However, we view Conexus as well placed to mitigate the pressure as the Baltics stopped receiving Russian gas on April 1, 2022, turning toward the U.S. and imports of liquefied natural gas (LNG) through Lithuania's LNG platform.

Rating Component Scores

| | |
|--|-----------------------|
| Foreign currency issuer credit rating | BBB+/Stable/-- |
| Local currency issuer credit rating | BBB+/Stable/-- |
| Business risk | Strong |
| Country risk | Intermediate |
| Industry risk | Very Low |
| Competitive position | Satisfactory |
| Financial risk | Aggressive |
| Cash flow/leverage | Aggressive |
| Anchor | bb+ |
| Diversification/portfolio effect | Neutral (no impact) |
| Capital structure | Neutral (no impact) |
| Financial policy | Neutral (no impact) |
| Liquidity | Adequate (no impact) |
| Management and governance | Fair (no impact) |
| Comparable rating analysis | Positive (+1 notch) |
| Stand-alone credit profile | bbb- |

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
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, 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
- Criteria | Corporates | General: Corporate Methodology, 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

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