

Credit Opinion: Lenenergo, JSC

Global Credit Research - 31 Jan 2013

St. Petersburg, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba2
NSR Corporate Family Rating -Dom Curr	Aa2.ru

Contacts

Analyst	Phone
Ekaterina Botvinova/Moscow	7.495.228.6060
Helen Francis/London	44.20.7772.5454
Monica Merli/London	

Key Indicators

Lenenergo, JSC[1]	LTM H1 2012	12/31/2011	12/31/2010	12/31/2009	12/31/2008
FFO Interest Coverage [2]	3.1x	3.1x	5.1x	5.1x	8.1x
Net Debt / Net Fixed Assets	24.8%	27.9%	21.8%	23.6%	22.9%
FFO / Net Debt [2]	20.4%	16.4%	38.1%	32.3%	69.1%
RCF / Capex	0.3x	0.3x	1.1x	0.9x	1.0x
Debt / EBITDA	2.6x	2.8x	1.5x	2.2x	3.3x
EBITA margin	16.6%	15.9%	22.6%	20.3%	17.6%

[1] All ratios are calculated according to Moody's standard analytical adjustments, if not mentioned otherwise. [2] FFO figures incorporate a non-standard adjustment (reclassification of cash advances for network connections).

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

Headquartered in the city of St. Petersburg, JSC Lenenergo (Lenenergo) is one of Russia's major regional electricity distribution grid companies, focused on the St. Petersburg region (including the city of St. Petersburg and the Leningrad oblast). The company services a territory of 87,300 sq km with a population of 6.2 million people. Lenenergo is a regulated natural monopoly, whose electricity transmission revenues accounted for around 75.2% of its 2011 total revenues of RUB37.8 billion (before normal technological losses). The largest shareholder of Lenenergo is the state-controlled IDGC Holding (Ba1 developing), which directly holds 53.41% and indirectly, through its another subsidiary, IDGC of Urals (Ba2 stable), owns additional 7.15% of Lenenergo's voting shares. A blocking stake of 26.57% of voting shares is owned by the government of the city of St. Petersburg (Baa1 stable).

Rating Rationale

Lenenergo's Ba2/Aa2.ru ratings incorporate: (1) the higher risk of the company's regulated grid business in Russia compared with the generally low business risk profiles of its peers in developed markets; (2) the company's financial profile and liquidity, which are pressured by its large investment programme; and (3) some degree of shareholder/state support available to the company given its advantageous shareholder structure and its strategic role in the economy of the St. Petersburg region, one of the wealthiest regions in Russia. The company's higher business risk is attributed to the evolving regulation of the Russian grid sector and the sector's restructuring, with IDGC Holding to be renamed Russian Grids and become the management company for the sector. Moody's incorporates a one-notch uplift in Lenenergo's ratings for the support from its shareholders.

Rating Drivers

Moody's evaluates Lenenergo's ratings by applying the Rating Methodology for Regulated Electric and Gas Networks, which identifies key factors for assessing the relative fundamental credit quality of regulated networks. Based on the company's historical financial performance, the methodology grid would map Lenenergo to a Baa3 category. Similar to other rated Russian electric utilities, the gap between the methodology grid indicated assessment and the actual rating incorporates a degree of uncertainty associated with the long-term evolution of Lenenergo's financial profile in the immature Russian operating environment. Lenenergo's ratings also incorporate positively the availability of shareholder support, which is not an industry-specific factor and thus not considered in the methodology grid.

Rating Factor 1 - Regulatory Environment and Asset Ownership Model

The stability and predictability of the regulatory regime for Russian grids, including Lenenergo, scores B. The evolving regulation and grid sector's configuration is the key risk and a key component in determining their ratings, suppressing differences in their credit profiles. Electricity transmission tariffs remain subject to political interference even within the regulatory asset base (RAB) model, which was implemented to improve transparency of tariffs and attract investments to the grid sector but has not been consistently applied so far. At end-2011, to cap tariff growth rates for end users, the state initiated a revision of RAB parameters for grids with a possible switch of a few grids to a long-term indexation regulation. The process was completed by November 2012; Lenenergo is among the majority of the grids which remain under the RAB regulation. We see the revision and numerous adjustments of the recent past as both a sign of political pressure and a confirmation of the regulators' developing approach. Overall, tariff growth for grids is limited to 11%, 10% and 10% from the middle of 2012, 2013 and 2014, respectively. Lenenergo will see a somewhat higher average tariff growth rate (15% for 2013 and 14% for 2014) as an exception allowed by the regulators recognizing a particularly low tariff increase for Lenenergo in 2011, the company's strategic importance and significant investment needs. However, in our view, this deviation from the set tariff growth cap for domestic grids may increase the likelihood of further tariff revisions for Lenenergo.

At the same time, overall, we expect that the regulatory decisions for Lenenergo will continue to take into account the strategic importance of the company's business to Russia's North-West region and support a degree of correlation between adjustments to tariff and those to the company's investment programme. We understand that 2012 cash equity injections from state-related shareholders were factored in the tariff decisions for 2011-12 for the company. However, with inadequate through-tariff cover for its large investment needs, the company scores a Ba under the cost and investment recovery sub-factor.

The company's connection charges revenue, which is sourced mainly from new and/or expanding businesses, has had a mixed impact on its cash generation. This has been positive as an additional revenue source to finance the company's investment needs. However, this source was more vulnerable during the crisis. Given the relatively high share of connection charges in Lenenergo's total revenue (22.8% in 2011), although the share decreases following the RAB regime introduction (17.2% in H1 2012), we believe the company is exposed to some level of revenue risk, and thus scores Ba for the revenue risk sub-factor.

Lenenergo owns and controls its network assets, without being a subject to a licence, lease or concessionary agreement. Under the circumstances, given the lack of a legally well-defined and tested procedure for dispossessing a natural monopoly business of its assets in case of its insolvency in Russia, the dispossession risk for Lenenergo is currently seen as immaterial. The company's ownership structure dominated by state-related shareholders contributes to this view, which results in the Aaa score under the asset ownership model sub-factor.

Rating Factor 2 - Efficiency and Execution Risk

Lenenergo is broadly in compliance with quality and reliability benchmarks set by the regulators, with no deviations being subject to a penalty. At the same time, as with other domestic distribution grid businesses, Lenenergo is yet

to demonstrate its ability to sustainably deliver costs savings under the RAB-based regulation, a challenging task, given the company's significantly outdated assets and a relatively high electricity loss level compared to the average level in IDGC Holding (10.6% compared to 8.4%, respectively, in 2011). We also take into account the known vulnerability of the outdated assets of the domestic grid sector to harsh weather conditions, the grid sub-sector's significant investment needs and operational shortcomings. Overall, Lenenergo scores a Ba under the efficiency sub-factor.

Lenenergo remains challenged by a large investment programme. Though the programme has been reduced a few times since April 2011 in line with a few revisions of tariffs, it remains significant (RUB87.9 billion for 2012-2017). We note that the company's flexibility in delaying investments may be relatively limited, given the old asset base that suffered from underinvestment of the past. We view the scale and execution risk of the company's investment programme as commensurate with the B rating category.

Rating Factor 3 - Stability of Business Model and Financial Structure

Although Lenenergo is a fully regulated natural monopoly grid business with no plans to alter its business profile, we assess it relatively conservatively (Baa) under the sub-factor of stability of its business model. The assessment factors in uncertainties surrounding the grid sector's configuration and, more broadly, the state strategy for the sector, including privatization plans. The assessment of the company under the sub-factor of targeted proportion of operating profit outside core activities corresponds to the assessment of the business model's stability.

The company scores Ba on its ability to increase its leverage, taking into account its large investment needs and the fact that it is predominantly funded by state-controlled banks, which are likely to be supportive if the company were to consider an increase in its leverage and would deviate from financial covenants under bank facilities.

Rating Factor 4 - Key Credit Metrics

Lenenergo's financial profile has remained consistent with the current rating, though without cushion under FFO interest coverage ratio. In mid-2012, the company's debt/EBITDA for H1 2012 on a last-12-months (LTM) basis was 2.6x, FFO interest coverage was 3.1x and funds from operations (FFO)/net debt was 20.4%, including Moody's adjustments.

However, given the limited transmission tariff growth and its large investment programme, Lenenergo risks seeing its financial profile deteriorate in the short term. The risk is particularly high for the next half a year, as no tariff increase is expected until mid-2013. Additional pressure may be created if connection charge proceeds appeared more volatile than expected. In our view, the deterioration may even go beyond our guidance for the current rating, FFO Interest coverage of 3x and FFO/Net Debt in midteens. Similarly, some financial covenants under bank agreements may appear stressed in the short term.

However, we currently expect Lenenergo to be able to reasonably limit any deviation from the current rating guidance and restore its financial metrics by end-2013, based on the support from its major shareholders, the state-controlled IDGC Holding and the government of the city of St. Petersburg. Both shareholders are expected to be able to (1) help the company adjust its investment plans to available funding and reasonably prudent leverage targets and also (2) facilitate its access to external funding to comfort its liquidity profile.

Liquidity Profile

Lenenergo's liquidity position remains dependent on its ability to attract reasonably in advance funding for its investment programme and maintain a long-term debt maturity profile. At the same time, being a monopoly business, Lenenergo is required to attract bank resources under time-consuming tender procedures, which may limit its flexibility in procuring additional liquidity. We particularly note a still limited track record of advance arrangements for committed back-up facilities. We understand that, as it is not uncommon in Russia, Lenenergo's liquidity management policy has largely factored in its status of a state-related monopoly and established relationship with state-owned banks and does not necessarily require funding needs to be addressed far in advance.

According to Lenenergo's interim condensed IFRS financial statements for H1 2012, in mid-2012, short-term debt obligations accounted for less than 2% of total debt and were more than covered by cash reserves of RUB6.5 billion. According to management's data, as of end-2012, Lenenergo's short-term debt under bank facilities amounted to around RUB3 billion, or approximately 11% of the company's total debt of around RUB27.6 billion, excluding finance lease obligations, and remained more than covered by the company's cash reserves. However,

end-2012 liquidity cushion including both cash reserves and undrawn funds under committed bank facilities is likely to be temporary due to large investments. Moreover, depending on its actual capex schedule in 2013, Lenenergo may see some of its financial covenants under bank facilities significantly pressured.

That said, Moody's acknowledges Lenenergo's good relationship with state-owned banks and expects the latter to remain supportive for the company. Moody's understands that the company continues to negotiate long-term bank funding to facilitate its investments. The agency also positively notes Lenenergo's access to domestic bond market: in April 2012, Lenenergo successfully placed a 3-year RUB3 billion bond. Overall, state-related shareholder support, which was particularly confirmed by 2012 cash equity injection, helps the company mitigate pressure on its liquidity and financial profile. In our view, the liquidity pressures are currently accommodated under the company's rating due to the support from shareholders.

Rating Outlook

The rating outlook is stable, as we believe that the company has sound and prudent plans to develop and adjust its business in close interaction with its shareholders taking into account the availability of funding, tariff evolution and the wider economic environment. We do not exclude that Lenenergo's financial metrics may fall below the current rating guidance by mid-2013 but expect that this will be temporary and reversed by end-2013. The stable outlook also factors in the company's relatively low positioning compared with the ratings of peers in the developed markets.

What Could Change the Rating - Up

No upward pressure on the rating is expected, given the current evolving regulatory environment for Russian grids and the grid sector's restructuring.

What Could Change the Rating - Down

However, negative pressure on the company's ratings could result from (1) weakening support from its shareholders, (2) a material negative shift in the developing regulatory regime and deteriorating margins, (3) failure to manage investments in line with tariff decisions and hence limit deterioration of the company's financial profile, with total FFO interest coverage and FFO/Net Debt falling materially and persistently below 3.0x and below midteens, respectively. Furthermore, if Lenenergo were unable to address its liquidity needs and appeared not be supported by its bank creditors with regard to its covenant standing, negative pressure could be exerted on the ratings.

Rating Factors

Lenenergo, JSC

Regulated Electric and Gas Networks	Aaa	Aa	A	Baa	Ba	B
Factor 1: Regulatory Environment & Asset Ownership Model (40%)						
a) Stability and Predictability of Regulatory Regime						X
b) Asset Ownership Model	X					
c) Cost and Investment Recovery					X	
d) Revenue Risk					X	
Factor 2: Efficiency & Execution Risk (10%)						
a) Cost Efficiency					X	
b) Scale and Complexity of Capital Programme						X
Factor 3: Stability of Business Model & Financial Structure (10%)						
a) Ability and Willingness to Pursue Opportunistic Corp. Activity				X		
b) Ability and Willingness to Increase Leverage					X	
c) Targeted Proportion of Op. Profit Outside Core Reg. Activities				X		
Factor 4: Key Credit Metrics (40%) (3 Year Avg) [1][2]						
b) FFO Interest Coverage [3]			4.7x			
d) Net Debt / Net Fixed Assets	23.4%					
e) FFO / Net Debt [3]	33.0%					
f) RCF / Capex					0.7x	

Rating:						
a) Indicated Rating from Grid				Baa3		
b) Actual Rating Assigned					Ba2	

[1] All ratios are calculated using Moody's Standard Adjustments, if not mentioned otherwise. [2] As of June 30, 2012; Source: Moody's Financial Metrics. [3] FFO figures incorporate a non-standard adjustment (reclassification of cash advances for network connections).



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