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Research Update:

German Utility innogy 'BBB/A-2' Ratings Affirmed Following Announced Acquisition By E.ON; Outlook Stable

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Overview

- German utility E.ON SE plans to acquire RWE's 76.8% stake in innogy, which we assume--if completed as envisaged--would lead to innogy's full integration into the E.ON group.
- As a result, we would likely regard innogy as a core subsidiary of E.ON and equalize our ratings on innogy with those on E.ON.
- We are affirming our 'BBB/A-2' ratings on innogy.
- The stable outlook reflects our view that innogy will maintain its current stand-alone creditworthiness and continue to operate independently from E.ON until its acquisition, with funds from operations to debt at 16%-18%.

Rating Action

On March 13, 2018, S&P Global Ratings affirmed its 'BBB/A-2' long- and short-term issuer credit ratings on German utility innogy. The outlook is stable.

At the same time, we affirmed our 'BBB' issue rating on innogy's senior unsecured notes.

Rationale

The affirmation follows E.ON's announcement that it has reached an agreement with RWE AG to acquire RWE's 76.8% stake in innogy through a wide-ranging exchange of assets. The transaction means that innogy would retain its regulated power networks operations and retail supply business, but its renewables business (mainly wind power) and gas storage operations would be transferred to RWE (see "German Utility E. ON 'BBB/A-2' Ratings Affirmed Following Asset Swap With RWE; Outlook Remains Stable," published March 13, 2018, on RatingsDirect).

If the transaction is completed as contemplated, innogy would add about €13.5 billion of regulatory assets to E.ON's asset base, increasing the regulatory asset value to about €37 billion. As such, we would assume innogy to be a core subsidiary of E.ON. In addition, we understand E.ON will make a public offer to acquire the remaining shares in innogy and intends to fully integrate innogy into the E.ON group. As a result, we will likely equalize our ratings on innogy with those on E.ON after the transaction closes.

We understand that the transaction involves various interconnected stages, including antitrust clearance, and final completion may take place only in 2020. We will therefore continue to monitor innogy's credit quality under the current set-up until we have visibility about the final transaction terms and closing.

innogy is one of the largest utilities in Germany, with S&P Global Ratings-adjusted EBITDA of about €4.5 billion in 2017. The company's strong business risk profile continues to reflect our view of its highly visible cash flow generation from a mix of:

- Purely regulated activities in German and Eastern European gas and power distribution, which we estimate represent about half of EBITDA and benefit from a strong regulatory framework;
- Power and gas supply (about 25% of EBITDA) to a portfolio of relatively stable business-to-consumer clients in Germany, the Netherlands, the U.K., and Eastern Europe;
- Renewables operations (15%), mainly comprising wind, with the majority of earnings not subject to price volatility; and
- Other operations (reported under its Grids and Infrastructure segment), including gas storage and water operations in Germany (estimated at 5%-10%).

We anticipate the company's regulated power networks will continue to demonstrate stable performance. These account for about 50% of total EBITDA, of which the majority comes from Germany. We consider the German regulatory framework for electricity and gas distribution to be strong, based on its high visibility, predictability, and stability (see "Why We See Germany's Electricity And Gas Regulatory Framework As Supportive," published Nov. 21, 2016).

We also view the company's renewables generation portfolio as favorable. It consists of onshore and offshore wind production under long-term subsidy schemes (with an average life for onshore schemes of about eight years and an average life for offshore schemes of about 12 years), and low-cost hydropower. innogy also has a relatively large embarked investment pipeline in offshore wind to be commissioned after 2020. That said, competition for new wind contracts is increasing, and we believe this will limit the company's growth opportunities in this area. The markets for the supply of power and gas are also increasingly competitive. We expect earnings pressure in this segment to be partly mitigated by ongoing cost-cutting efforts. We also note innogy's agreement with SSE PLC to contribute its U.K. retail operations to form a new entity, in which innogy will have a minority stake.

We expect that innogy's credit metrics will be relatively stable, including adjusted funds from operations (FFO) to debt remaining at 16%-18% in 2018, similar to the 2017 level. We also assume EBITDA will be relatively stable, and operating cash flows will essentially cover capital expenditures (capex) and dividends, leading to a relatively steady debt position.

In our base-case scenario for innogy in 2018, we assume:

- Adjusted EBITDA of €4.4 billion-€4.5 billion, due to pressure from the supply activities, but modest growth in renewables as assets are commissioned, and a stronger contribution from network operations;
- Reducing cost of debt, supported by cheaper refinancing of debt (about €1.8 billion maturing in the next 12 months);
- Annual capex of about €2.5 billion, largely on regulated networks and renewables; and
- Cash dividends in line with the group's financial policy of paying out 70%-80% of net recurring income.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt remaining at 16%-18%;
- Adjusted debt to EBITDA remaining at 4.0x-4.2x; and
- Neutral to slightly negative discretionary cash flows.

Until the asset swap between RWE and E.ON is completed, we expect that innogy will continue to operate independently from RWE in strategic and financial terms. We consider that, for now, innogy will provide RWE with a stable dividend. We therefore currently maintain our view that the rating on innogy cannot be completely delinked from our 'bbb-' assessment of RWE's group credit profile (GCP). However, the long-term rating on innogy could be one notch above the GCP, as long as innogy's stand-alone credit profile (SACP) remains at least one notch higher than the GCP.

We note innogy's announcement in December 2017 of a change in strategic direction, including increased investment levels, and the subsequent departure of its CEO. The company has since stated that it will pursue a focused growth and investment strategy, underscoring our assumption that it will maintain credit measures in line with the 'BBB' rating.

Liquidity

We analyze innogy's liquidity on a stand-alone basis. We assess innogy's liquidity as strong based on our projection that its liquidity sources will exceed liquidity uses by more than 1.5x over the next 12 months and by 1x over the following 12 months. We also anticipate that sources would cover uses even if EBITDA declined by 30%.

We also consider innogy's proven access to capital markets. The company's bond and loan documentation does not include financial covenants, which further supports financial flexibility.

Principal liquidity sources as of Dec. 31, 2017, include:

- About €3.3 billion in available cash and short-term marketable securities;
- Our estimate of cash FFO of approximately €3 billion over the next 12 months;
- A €2 billion revolving credit facility with a five-year tenor and two-year extension options, signed in October 2017; and
- €1 billion of notes issued under a Euro medium-term note program in January 2018 for refinancing purposes.

Principal liquidity uses as of the same date include:

- Short-term debt maturities of approximately €1.8 billion in the next 12 months;
- Dividend payments of approximately €1.3 billion, including to minority shareholders; and
- Annual capex of about €2.5 billion.

Outlook

The stable outlook reflects our view that innogy's SACP will remain at 'bbb', supported by stable performance from grid operations, with FFO to debt at 16%-18% over the next two years. We expect to equalize our ratings on innogy with those on E.ON if the transaction between E.ON and RWE is completed as envisaged. Until then, we expect innogy will continue to operate independently from RWE in financial and strategic terms.

Upside scenario

We currently see upside in the rating as constrained by:

- The GCP of the consolidated RWE group (including innogy) being at 'bbb-';
- Our view of innogy's SACP at 'bbb'; and
- The likelihood that we would equalize our ratings on innogy with that of 'BBB' rated E.ON once E.ON's planned acquisition of innogy is completed.

Downside scenario

Although we see risks to innogy's SACP as remote at this stage, we could lower the rating if innogy's financial policy became more aggressive, with the company making higher-than-anticipated cash payments for investments or dividends, leading to deteriorating credit measures, including FFO to debt below 15% for a prolonged time. We could also consider lowering the rating if we saw weakening of RWE group's credit quality and a lower likelihood that E.ON would complete its acquisition of innogy.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Strong
- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Stand-alone credit profile: bbb
- Group credit profile: bbb-
- Entity status within group: Highly strategic (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

innogy's capital structure consists of about €16 billion of unsecured bonds and loans at the parent or at innogy Finance B.V., with a guarantee from innogy. In addition, there is about €1 billion of unsecured loans at subsidiary level.

Analytical conclusions

We rate debt issued by the parent and subsidiary at 'BBB', the same level as the issuer credit rating on innogy, since no significant elements of subordination risk are present in the capital structure. We do not expect this situation to change in the event of innogy's acquisition by E.ON.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Why We See Germany's Electricity And Gas Regulatory Framework As Supportive, Nov. 21, 2016

Ratings List

Ratings Affirmed

innogy	
Corporate Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Innogy Finance B.V.	
Senior Unsecured	BBB

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