Fitch Revises EDF's Outlook to Negative; Affirms IDR at 'A-'

Wed 22 Apr, 2020 - 2:22 PM ET

Fitch Ratings - Milan - 22 Apr 2020: Fitch Ratings has revised Electricite de France's (EDF) Outlook to Negative from Stable, affirming the utilities group's Long Term Issuer Default Rating at 'A-'. A full list of rating actions is below.

The Outlook revision mainly reflects a large production cut in nuclear generation in France related to the coronavirus pandemic, and ongoing problems with new nuclear, adding to an expected increase in leverage to slightly above our rating sensitivity on average for 2020-2022. It also reflects growing uncertainties about the nuclear-market reform in France - which we still expect to be finally implemented - in terms of timing and final impact.

The rating of EDF reflects the weight of regulated activities in its business mix, its incumbent position in France, a clean, low-cost asset base, but also its operational problems (in particular for new nuclear), a rigid capex plan and its structurally negative free cash flows (FCF).

We have revised EDF's negative leverage sensitivity down by 0.2x to 4.0x, to mirror lower leverage due to a change in Fitch's approach towards lease transactions (now fully considered as operating spending with no capitalisation, versus rent capitalisation through a multiple previously).
KEY RATING DRIVERS

Production Cuts due to Pandemic: The pandemic and the lockdown have caused daily electricity demand to fall up to 20% yoy and depressed both spot and forward electricity prices. EDF has announced a cut of French nuclear production to 300TWh in 2020 and to 330TWh-360TWh for 2021-2022 (from our earlier assumption of 385TWh annually for the whole period), due mainly to the operational impact of the pandemic on the outages scheduled for these years and, to a lesser extent, to the drop in demand. While the announcement led to a rebound of forward prices 2021-2022 to around 45EUR/MWh, we do not expect EDF to fully benefit from it due to the ARENH reference price of 42EUR/MWh. For 2020, EDF is largely protected from the low price environment through hedging.

Large Working Capital Outflows: Another immediate consequence of the pandemic has been an increase in the number of end-customers struggling to pay their bills. In this respect, EDF will continue to supply power to households and small companies with overdue bills without penalties. We view this as socially responsible behaviour, and include in our forecasts a large cash-out from working capital in 2020, related mostly to delayed receivables collection, and broadly flat working capital in the following years.

Market Reform Less Imminent: In our view the pandemic has increased uncertainties around the timing and the impact of the nuclear-market reform, as the French government focuses on addressing the socio-economic impact of the lockdown. Also, in the current market environment it could be hard to impose a reform that could ultimately translate into higher prices both for power suppliers and end-customers. However, we believe that the current circumstances are proving once more that the reform is key to strengthening EDF’s business profile and we assume that the government remains committed to the reform, although with a likely delay.

Price Corridor Would Provide Protection: Based on the consultation document, the reform should see the introduction of a price corridor (preliminarily defined at 6EUR/MWh) for the sale of electricity generated by EDF’s nuclear plants. The cap and the floor prices of the corridor have not yet been defined. This should resolve the key problems of the ARENH mechanism, which has a reference price at 42EUR/MWh (unchanged since 2012), which directly or indirectly applies to around 70% of EDF’s French electricity sales, and does not provide any protection from a market downturn.
High Leverage: We expect EBITDA on a reported basis to drop to around EUR15.5 billion in 2020 (from EUR16.7 billion in 2019), which coupled with cash absorption from working capital would result in a rise of FFO net leverage to 3.9x (from 3.5x in 2019). We forecast EBITDA to gradually recover to EUR16.2 billion in 2022, but leverage to rise to 4.2x in 2021-2022, as capex increases again after a drop assumed for 2020, also due to operational challenges.

Company’s Reaction Uncertain: EDF has not yet communicated revised financial targets to the market, and we do not know what actions it will focus on to mitigate the impact of the pandemic. In terms of cash flows and leverage, the impact could be mitigated by capex reduction - although we believe that capex is overall rather rigid - a greater focus on efficiencies, a renewed emphasis on disposals, which however would be hindered by the current challenging market environment. However, in light of our through-the-cycle approach, we will focus more on the structural features of the business risk and sustained leverage rather than its peak level.

Problems with New Nuclear: At Flamanville, fuel loading would occur at best at end-2022 (compared with the previously estimated late-2019), implying an increase of construction costs by EUR1.5 billion (in 2015 real terms and excluding interests during construction) compared with previous estimates. HPC - the other key nuclear project of EDF - following another cost review in September 2019, sees an increase in construction costs of GBP1.9 billion-GBP2.9 billion (2015 real terms) compared with previous estimates. It remains to be seen if the pandemic will further increase the delay and cost overrun for these projects.

Positive 2019 Results: EDF posted healthy results in 2019, with reported EBITDA showing an organic growth of around 8% and FFO rising 4%. FCF remained negative, although to a lower extent than in previous years and FFO net leverage, at 3.5x, was quite close to our positive rating sensitivity.

**DERIVATION SUMMARY**

We estimate regulated & contracted EBITDA at around 50% of total, some way below that of peers Engie S.A. (A/Stable), Enel S.p.A. (A-/Stable), Iberdrola S.A. and E.ON SE (BBB+/Stable).

We view the debt capacity of the peers as broadly similar, since EDF compensates its lower regulated EBITDA proportion with a clean and low-cost...
asset base, an incumbent position in France and a good country-mix exposure. As a consequence, the rating differential mainly reflects different levels of leverage. Compared with peers, EDF's financial profile is penalised by negative FCF expected across the company's business plan. So far, the pandemic has had a greater impact on EDF compared with peers.

KEY ASSUMPTIONS

- French nuclear output at 300TWh for 2020, and 330TWh for 2021-2022

- French hydro recovering to around 35TWh for 2020-2022

- Market prices in France remaining very weak for 2020, before rising above the ARENH level in 2021-2022. Margins in 2020 benefit from hedging as indicated by EDF at end-2019

- Enedis' EBITDA to follow regulated tariff increases; Linky to start contributing to EBITDA from 2020

- UK nuclear output below 60TWh in 2020-2022, but recovering from a low 51TWh of 2019

- Market prices in UK, Italy broadly in line with forward levels

- Cash tax as per guidance; cost of new funding at 3% up to 2022

- Allocations to dedicated assets related to nuclear provisions higher than management guidance

- Cash absorption from working capital of around EUR2.5 billion in 2020, and fairly stable thereafter

- Capex include extra costs at Flamanville 3 and Hinkley Point, but also a cut of EUR3.5 billion in 2020 and EUR1 billion in 2021 to reflect the operating environment

- No cash dividends for 2021-2022

- No disposals in 2020, then cumulative EUR1.5 billion in 2021-2022
RATING SENSITIVITIES

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

- For the Outlook to be revised to Stable: visibility on the introduction of the market reform for nuclear in France, with an increase in cash-flow predictability, for example through a cap-and-floor mechanism. Moreover, a recovery in credit metrics to levels stronger than those outlined in the negative sensitivities below.

- For an Upgrade: We do not anticipate an upgrade as reflected in the Negative Outlook. However, developments that may lead to an upgrade include

  - FFO net leverage below 3.3x on a sustained basis (2019: 3.5x)
  - FFO interest cover above 6.0x on a sustained basis (2019: 6.0x)
  - Sustained reduction in negative FCF
  - Market reform for nuclear in France leading to higher cash-flow visibility, for example through a cap-and-floor mechanism, or stronger links with the government

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

- FFO net leverage above 4.0x on a sustained basis
- FFO interest cover below 5.0x on a sustained basis
- A sustained decline in electricity prices in France, UK and Italy and / or further cuts to production
- Insufficient visibility on the implementation of a market reform for nuclear in France to provide protection against market downturn and yet further delay in new nuclear development

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions,
measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

At 31 December 2019, EDF had readily available cash comprising cash and cash equivalents of EUR3.7 billion, liquid assets of EUR17.1 billion and committed undrawn facilities of EUR10.5 billion, of which EUR1.4 billion would mature within one year. This means that EDF can cover scheduled debt maturities (around EUR13 billion for 2020-2021), capex and operating requirements into 2020-2021 without resorting to additional debt issue, even after taking into account the current operating environment impacted by the pandemic.

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.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

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EDF Energy Nuclear LT IDR A- Affirmed

Additional information is available on www.fitchratings.com

**APPLICABLE CRITERIA**

- Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)
- Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)
- Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)
- Government-Related Entities Rating Criteria (pub. 13 Nov 2019)
- Short-Term Ratings Criteria (pub. 06 Mar 2020)
- Corporate Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

**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)

**ADDITIONAL DISCLOSURES**

- Dodd-Frank Rating Information Disclosure Form
- Solicitation Status
- Endorsement Policy

**ENDORSEMENT STATUS**
EDF Energy Nuclear Generation Limited  EU Issued
Electricité de France (EDF)  EU Issued

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