



Fitch Affirms RWE at 'BBB', Stable Outlook

Fitch Ratings-Warsaw/London-05 October 2018: Fitch Ratings has affirmed RWE AG's Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB' and subordinated notes' rating at 'BB+' and removed them from Rating Watch Evolving. The Outlook on the Long-Term IDR is Stable. Fitch has also upgraded the Short-Term IDR to 'F2' from 'F3' and removed it from Rating Watch Positive. A full list of rating actions is at the end of this commentary.

The rating actions follow progress in the asset swap transaction with E.ON SE (BBB+/Stable), which will add a large renewable generation business to the mix and improve RWE's credit profile due to the quasi-regulated character of the new business. We do not anticipate a major impact from the rising CO2 and coal prices on RWE's conventional generation business, due to the high share of hedged positions at RWE and parallel increases in the wholesale electricity prices in the main markets of operations. The upgrade of the Short-Term IDR reflects our forecast for internal and external liquidity ratios mostly in line with 'F2' thresholds.

We have revised our rating guidelines to reflect the new business structure and nuclear decommissioning provisions, which will be covered by the 76.8% shareholding at innogy SE (BBB+/Stable) only until the asset swap concludes in late 2019. We anticipate that RWE's funds from operations (FFO) nuclear- and lease-adjusted net leverage will increase to about 2.4x over 2020-2022 from a negative position now.

KEY RATING DRIVERS

Rating Watch Resolved: We placed RWE's ratings on Rating Watch following the March 2018 announcement made by RWE and E.ON with respect to their asset swap. As part of the transaction, E.ON will receive the innogy stake owned by RWE (76.8%) in return for a 16.67% shareholding in E.ON issued to RWE. E.ON will also transfer to RWE innogy's and E.ON's renewable assets, as well as innogy's gas storage assets and its participation in the Austrian energy utility Kelag and E.ON's minority stakes in the RWE-operated power plants Emsland and Gundremmingen. In addition E.ON will receive EUR1.5 billion in cash from RWE.

Asset Swap Progress: RWE, E.ON and innogy have made progress towards the asset swap since the March 2018 announcement. This includes conclusion of a voluntary public takeover offer in July 2018, which was made to innogy's minority shareholders by E.ON and which raised E.ON's future stake in innogy to 86.2% from 76.8% to be acquired from RWE. Also in July 2018, innogy concluded two binding agreements each with RWE and E.ON, which aim for a smooth integration process and fair and equal treatment of employees and in Fitch's view, reduce execution risks for the transaction.

We assume that the transaction will be concluded in late 2019 as the asset swap is complex and requires approvals from regulatory bodies in various jurisdictions. Until then innogy will operate as a separate business with an independent supervisory board and an agreement on basic principles between innogy and RWE providing for a legal basis for innogy's independence from RWE.

Renewables Portfolio: After the asset swap, RWE will become one of the leading renewables players in Europe with a combined capacity of about 9GW, mostly in Germany, the UK and the US. We estimate that the remaining duration of the quasi-regulated revenues supported by various contracts and subsidies is about 10 years across the entire portfolio, with a slightly longer duration for offshore assets. It is not yet fully clear how the portfolio will be managed post-transaction. Nevertheless, we deem acquisition of a large renewables portfolio with a quasi-regulated income stream as positive for RWE's business and credit profiles.

Rising CO2 and Coal Prices: We expect that RWE's conventional generation business will not come under significant pressure from rising CO2 and coal prices over our rating horizon. This is due to RWE's hedging strategy, including over 90% of either fully or fuel-side hedged position by 2021 in the Lignite & Nuclear business unit, over 90% and over 80% hedged position in the European Power business unit in 2018 and 2019, respectively, and CO2 position financially hedged until the end of 2022. Furthermore, current trends in the wholesale electricity market prices tend to reflect higher production costs. The trend is visible even in the German market with its relatively high share of electricity produced from renewable and nuclear power plants. The results of the Lignite & Nuclear division could deteriorate if the dispute around expansion of the Hambach opencast mine prolongs.

Treatment of Nuclear Provisions: Following the sale of RWE's stake in innogy, Fitch will apply both a nuclear- and lease- adjusted FFO net leverage as RWE's rating guidelines, taking into account gross nuclear provisions net of dedicated financial assets and adjusting the FFO for the nuclear provision utilisation. The nuclear provisions amounted to about EUR5.6 billion at end-2017 (using a 0% discount rate). We estimate that the nuclear provisions will increase with the transaction due to RWE receiving E.ON's minority stakes in RWE's Gundremmingen (25.0%) and Emsland (12.5%) nuclear power plants.

Treatment of Hybrids: RWE has outstanding hybrids of about EUR2.1 billion, of which EUR1.6 billion is backed by two innogy loans. The first loan will be repaid in March 2019 and the second loan will be transferred to E.ON after the completion of the transaction and will be paid regardless of the instruments being called or replaced. Fitch assigns 50% equity credit only to the EUR0.5 billion part of hybrids not backed by innogy loans with the first call dates in 2025 and 2026. We may re-evaluate the treatment of the instruments or their replacement closer to their first call dates, depending on our assessment of permanence of RWE's capital structure strategy at that time.

Balanced Cash Flow Risk: With over 42GW of generation capacity and about 200TWh of electricity volumes produced, RWE is one of the largest power generators in Europe. We expect some medium-term visibility on the renewables portfolio after completion of the transaction. On

the other hand, RWE's cash flow will still be affected by pressures in the conventional generation business, nuclear phase-out in Germany to take place until 2022 and a working-capital-intensive and volatile trading business. Therefore the overall volatility of cash flows could still be larger than for some more integrated peers.

Rating Headroom: With a more resilient business profile after acquisition of the renewables portfolio, we see some potential for positive rating action, which we deemed unlikely when the company focused on thermal generation only. We anticipate that RWE's FFO nuclear- and lease-adjusted net leverage will increase to about 2.4x over 2020-2022 from a negative position now, which provides for some rating headroom under the current ratings and guidelines. Conservative dividend and capex policies backed by favourable market conditions could lead to lower leverage and a higher rating. We could relax the current rating guidelines after the asset swap with E.ON is completed and all transaction-related execution risks are eliminated.

DERIVATION SUMMARY

The current standalone RWE is more volatile than most of its peers, as the majority of its earnings come from power generation and trading. However, we estimate that following the completion of the transaction about 60% of RWE's EBITDA will come from quasi-regulated renewable generation, which is positive for RWE's credit profile and provides for higher debt capacity, as reflected in the revised rating guidelines.

RWE will remain a generation-focused utility with a high share of renewables in the portfolio, similar to e.g. Iberdrola, S.A. (BBB+/Stable), ENEL S.p.A. (BBB+/Stable) or Vattenfall AB (BBB+/Stable). Due to the lack of regulated distribution or transmission business in the mix as in the case of the above peers or fully integrated German peer, Energie Baden-Wuerttemberg AG (EnBW, A-/Stable), we deem RWE's credit profile as weaker and closer to that of Orsted A/S (BBB+/Stable) or Statkraft AS (BBB+/Stable). Similar to E.ON (BBB+/Stable) and EnBW, RWE continues to be responsible for near- and medium-term nuclear decommissioning provisions, which impact the financial profiles of these companies and increase credit risk.

KEY ASSUMPTIONS

- Wholesale electricity prices hedged at about EUR30 per MWh, hard coal prices at about USD90 per tonne and CO2 prices below EUR10 per tonne until 2022, we have reduced our EBITDA estimate by EUR150 million from 2019 due to the dispute around Hambach mine
- Asset swap with E.ON accomplished by the end of 2019
- About 60% contribution of quasi-regulated renewables to EBITDA from 2020
- Dividend from financial investment to decrease following innogy's disposal from about EUR0.6 billion net in 2017 to about EUR0.1 billion net in 2022
- Capex rising from about EUR0.5 billion per year in 2018-2019 to EUR1.9 billion per year in 2020-2022
- Dividends at about EUR0.5 billion per year from 2019

RATING SENSITIVITIES

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

- Nuclear and lease adjusted FFO net leverage below 2.0x on a sustained basis
- A disciplined investment strategy backed by a consistently conservative financial strategy
- A favourable power price environment leading to significantly higher than expected earnings

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

- Nuclear and lease adjusted FFO net leverage above 3.0x on a sustained basis
- Negative FCF through the cycle
- Minimum cash balance consistently below EUR2 billion

LIQUIDITY

Adequate Liquidity: At the end of 2017, on a standalone basis RWE had EUR3.6 billion of financial debt, which included EUR2.1 billion of hybrids (of which EUR1 billion is classified as equity in the accounts) and EUR0.5 billion of commercial paper. On top of this there was EUR1 billion of other financial liabilities, which included EUR0.4 billion margin calls received and financial leasing. Cash and cash equivalents amounted to EUR5.5 billion.

We assume that RWE will maintain a minimum liquidity cushion of at least EUR2 billion, which should mitigate some of the volatility in earnings, in particular until acquisition of the more stable renewables business.

FULL LIST OF RATING ACTIONS

RWE AG

- Long-Term IDR affirmed at 'BBB'; off Rating Watch Evolving; Stable Outlook;
- Senior unsecured rating affirmed at 'BBB'; off Rating Watch Evolving
- Subordinated notes rating affirmed at 'BB+'; off Rating Watch Evolving
- Short-Term IDR upgraded to 'F2' from 'F3'; off Rating Watch Positive

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Summary of Financial Statement Adjustments - 50% equity credit is applied to the 2025 and 2026 hybrid, a multiple of 8x is used to capitalise operating leases, innogy's figures are deconsolidated as we analyse RWE on a standalone basis. The 2017 transfer of funds related to nuclear waste provisions to the German state (EUR6.8 billion negative) net of reimbursement of nuclear fuel tax (EUR1.7 billion positive) was reclassified to Non-operating/Non-recurring cash flow.

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Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub. 27 Mar 2018) (<https://www.fitchratings.com/site/re/10024296>)
Corporate Rating Criteria (pub. 23 Mar 2018) (<https://www.fitchratings.com/site/re/10023785>)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (<https://www.fitchratings.com/site/re/10024585>)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018) (<https://www.fitchratings.com/site/re/10036366>)
Sector Navigators (pub. 23 Mar 2018) (<https://www.fitchratings.com/site/re/10023790>)

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