FitchRatings

Fitch Affirms RWE at 'BBB', Stable Outlook

Fitch Ratings - Warsaw - 26 March 2020:

Fitch Ratings has affirmed RWE AG's Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook is Stable. A full list of rating actions is detailed below.

The affirmation of the ratings reflects RWE's expansion in the renewables business, improved credit profile due to the quasi-regulated character of the company's new business and greater visibility over conventional generation provided by the coal exit agreement. The main long-term risk relates to high capex for further development of wind and photovoltaic (PV) generation. In the medium term RWE could be disrupted by a severe decrease in electricity demand.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
RWE AG	LT IDR BBB ⭘ Affirmed	BBB ⭘
	ST IDR F2 Affirmed	F2
senior unsecured	LT BBB Affirmed	BBB
subordinated	LT BB+ Affirmed	BB+

Key Rating Drivers

Asset Swap Approved: An asset swap between RWE and E.ON SE (BBB+/Stable) was approved by the EU Commission in 3Q19. As part of the transaction, RWE acquired renewables generation fleets of E.ON and innogy SE (BBB+/Stable) as well as a 16.7% stake in E.ON along with some smaller assets such as minority stakes in Austrian utility KELAG and in RWE nuclear power plants AKW Gundremmingen and Emsland. The on-boarding of E.ON's renewables and minority stakes has been completed, whereas integration of innogy's renewables should be finalised in mid-2020.

Large Renewables Fleet: The asset swap has allowed RWE to expand its renewables fleet by 8.7GW to 9.9GW at end-2019 on a pro-rata basis. The company has also acquired 2.7GW of under-construction renewables capacity as well as a portfolio of over 20GW of renewables capacity at various stages of development. The acquired wind and PV capacity is located mostly in Germany, the UK and the US and around 70% benefit from support mechanisms and with an average remaining tenor of 11 years. Expansion in the renewables business is positive for RWE's credit profile as it contributes to earnings stability and lowers the company's carbon footprint.

Changed Business Mix: We forecast the share of wind and PV generation in RWE's EBITDA at around 60% over 2020-2022. Contribution from both the hydro/biomass/gas and coal/nuclear divisions should be close to 20% each. The supply & trading division may come under pressure due to high volatility and declines in commodities markets triggered by the COVID-19 outbreak. The pandemic may also result in lower demand for electricity, especially in a prolonged recession. However, we do not anticipate a material impact on RWE's generation business due to an expected recession in Germany in 2020 and RWE's good position in the merit order and hedged position.

Coal Exit Agreement: In January 2020 the German government agreed with public and private stakeholders on the timing and method of the lignite phase-out. Lignite plant operators will receive a fixed compensation of EUR4.35 billion in total over 15 years for the early capacity phase-out. Compensations for hard-coal capacity are not fixed, but utilities will be allowed to tender for shutdowns ahead of schedule from 2020 till 2026, in return for compensation payments. For the following years compensations are unlikely.

Improved Visibility for Lignite: RWE will begin phasing out lignite from 2020. It will receive EUR2.6 billion of compensation payments over 15 years, which will cover most of the EUR3.5 billion of associated additional costs. This is supportive of RWE's credit profile as it eliminates uncertainty and increases visibility around the future performance of lignite operations.

New Strategy: In its March 2020 updated strategy RWE aims to further expand in wind and PV generation to over 13GW in 2022 (from 8.7GW in 2019), build-out of batteries and green power commercialisation. Coal-fired generation (12.7GW at end-2019) will be gradually phased-out by 2038 with interim targets of below 10GW in 2023 and 4.3GW in 2030. Implementation of the strategy will be capex-intensive, but RWE intends to keep leverage at a moderate maximum 3x net debt-to-core EBITDA. We deem the transition to greener fuel mix as positive for the business profile and compliant with the EU's decarbonisation policy and climate-neutrality goal for 2050.

Consolidated Approach: Due to the asset swap, Fitch has returned to analysing RWE on a consolidated basis (effective from 2019), versus its previous approach in 2016-2018, when RWE's stake in innogy was treated as a financial investment, accounted for with an equity method, and assigned to cover RWE's nuclear provisions. This implies application of a nuclear- and lease-adjusted funds from operations (FFO) net leverage as rating guideline from 2019, taking into account gross nuclear provisions and adjusting FFO for the nuclear provision utilisation.

E.ON Stake Adds Financial Flexibility: RWE's stake in E.ON, together with compensation payments from the government for the coal phase-out, has been assigned to cover mining provisions. The current value of the E.ON stake (EUR3.7 billion) and the compensation payments (EUR2.6 billion) exceed mining provision (EUR4.6 billion) contributing to RWE's financial flexibility.

Revised Leverage Guidelines: RWE's new business structure focusing on renewables (with 70% of them in addition benefitting from support schemes), a new strategy and greater visibility over the lignite business due to the coal exit agreement has led us to relax our rating sensitivities for FFO adjusted net leverage to 2.5x-3.5x. Our rating case forecasts FFO-adjusted net leverage at an average 2.9x over 2020-2022, leaving the company with significant rating headroom or scope for an upgrade should RWE outperform in its strategy delivery.

ESG Influence: ESG issues impact the ratings primarily through a high share of coal in RWE's generation fuel mix. This leads to lower debt capacity given that more restrictive environment policies create long-term, downward pressure on earnings and trigger additional capex for energy transition. However, RWE has been reducing its carbon footprint and is on a decarbonisation path with the CO2 neutrality goal set for 2040.

Derivation Summary

RWE is a generation-focused utility with a large conventional fleet, but due to the acquisition of the renewables portfolio from E.ON and innogy most of RWE's EBITDA will originate from renewables. This makes RWE comparable to Orsted A/S (BBB+/Stable), which, however, has a higher debt capacity due to a greater proportion of renewables to conventional capacity.

Due to expansion in renewables, RWE's business profile will evolve towards that of other generation-focused utilities with a high share of renewables in the portfolio such as Enel S.p.A. (A-/Stable), Iberdrola, S.A. (BBB+/Stable) or Statkraft AS (BBB+/Stable).

The lack of regulated distribution or transmission business makes RWE's credit profile weaker than that of German peer EnBW (BBB+/Stable). RWE's credit profile is stronger than Fortum Oyj's (BBB/RWN) due to Fortum's acquisition of Uniper SE. Similarly to EnBW and E.ON, RWE is responsible for near- and medium-term nuclear decommissioning provisions, which impact the financial profiles of these companies and increase their credit risk.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Close to fully hedged position in generation in electricity, coal and CO2 prices, delaying the impact of current price fluctuations, but at the same time providing for stable results with average EBITDA at around EUR2.9bn and 60% contribution of renewables until 2022

- Capex at EUR10 billion over 2020-2022, co-financed from disposal proceeds

- Dividends at about EUR0.5 billion per annum for 2020-2022

RATING SENSITIVITIES

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

- Nuclear- and lease-adjusted FFO net leverage below 2.5x on a sustained basis

- No material adverse changes to generation volumes or trading activities

- A disciplined investment strategy backed by a conservative financial strategy

- A sustainably favourable power commodity market 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 3.5x on a sustained basis

- Economic downturn resulting in prolonged fall in demand for electricity

- Negative FCF through the cycle

- Minimum cash balance consistently below EUR2 billion

Liquidity and Debt Structure

Healthy Liquidity: At end-2019, RWE's readily available cash stood at EUR6 billion. Additionally, it had EUR5 billion of committed and undrawn credit facilities. This line consists of two tranches with extension options (A: EUR3 billion, tenor 5+1+1, at lender's discretion; B: EUR2 billion, tenor 2+1+1, at borrower's discretion). RWE plans to exercise the first extension option on tranche B in March 2020.

Short-term financial liabilities at end-2019 amounted to EUR1.8 billion. Fitch calculates FCF for 2020 at a negative EUR1.3 billion due to high capex.

As per our rating case RWE has healthy liquidity, sufficient for the whole rating horizon until 2022.

Summary of Financial Adjustments

-Operating lease capitalised at 8x.

-50% equity credit applied to RWE's 2025 and 2026 hybrids.

-Stocks and profit-participation certificates (EUR449 million at end-2019) excluded from readily available cash.

-Variation margins reclassified to non-operating/non-recurring cash flow from working capital.

ESG Considerations

RWE has ESG credit relevance scores of 4 in categories "Emissions from Operations" and "Fuel Use to Generate Energy".

The remaining ESG credit relevance scores are no higher than 3, which means they are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)
Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)
Short-Term Ratings Criteria (pub. 06 Mar 2020)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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