FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades RWE to 'BBB+'; Stable Outlook

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Fitch Ratings - Warsaw - 25 Mar 2021: Fitch Ratings has upgraded RWE AG's Long-Term Issuer Default Rating (IDR) to 'BBB+' from 'BBB' with a Stable Outlook, and its subordinated notes' rating to 'BBB-' from 'BB+'. A full list of rating actions is below.

The upgrade reflects RWE's continuous expansion in renewable generation, which drives EBITDA increase, is carbon-free and mostly quasi-regulated thanks to support mechanisms. It also reflects visibility of conventional generation provided by the coal exit agreement in Germany and the equity increase in 2020, as well as compensation for the accelerated nuclear phase-out in Germany agreed in 2021. We believe these factors will drive RWE's leverage sustainably below the positive rating guideline for the previous rating.

The main long-term risk is a more aggressive than expected growth strategy, possibly with the revision of the target leverage of the company, or underperformance of the merchant business, which still represents around 50% of the EBITDA.

Feedback

KEY RATING DRIVERS

Large Renewables Fleet: RWE expanded its renewable generation fleet to 10.8GW at end-2020 (on a pro-rata basis) from 9.9GW at end-2019 and 1.2GW at end-2018. We expect the overall capacity (41GW at end-2020) to be largely unchanged over 2021-2024. However, the share of renewables should trend towards 50% by the mid-2020s (26% at end-2020) at the cost of lignite, hard coal and nuclear, which will have a positive impact on RWE's business profile.

High Contribution from Renewables: The already high contribution to EBITDA from renewables (2020: 48% from wind and solar), combined with RWE's plans of further expansion, have sustainably improved the company's business profile contributing to the upgrade. Including the hydro/biomass/gas division, the total contribution was 67%, while adding the supply & trading division (all forming core businesses as defined by RWE) makes a total contribution of 83%. EBITDA composition is therefore already skewed towards zero- or low-carbon generation, but actual generation volumes need to follow.

Non-core Business to Diminish: RWE's non-core businesses (17% of 2020 EBITDA) is lignite, hard coal and nuclear generation. Lignite and nuclear generation are located in Germany and will be gradually phased out with the final dates set by law 2038 for lignite and 2022 for nuclear. The earlier shutdowns will generally be compensated, limiting financial losses from lost generation volumes and stranded assets.

Compensation for Coal: RWE will receive EUR2.6 billion compensation for earlier closures of lignite-fired power plants, which will be paid in equal instalments over 15 years and cover most of the EUR3.5 billion of additional costs of the lignite phase-out. The mechanism is already implemented into German law, but is pending clearance from the EU for state aid rules. Hard coal-fired assets will be able to participate in auctions to be compensated for shut-down. The first auction was in 2H20 and RWE won compensation for its last two hard coal-fired power plants in Germany, totaling 1.6GW, which stopped operations end of 2020.

Compensation for Nuclear: The German government has agreed to compensate nuclear power plant operators for lost electricity volumes and stranded investments due to the enforced nuclear phase-out decided after the 2011 Fukushima disaster. RWE should receive EUR880 million. The settlement will conclude all pending legal disputes related to this topic, but it is pending implementation into German law and EU review for state aid rules.

Feedback

Equity Increase: In 2020, RWE raised EUR2 billion in equity (share capital up by 10%), intending to accelerate growth in wind and solar power. We deem this as positive for RWE's credit profile as it provided non-debt funding for green investments and lowered our leverage expectations for 2021-2024.

Rising CO2 Prices: RWE remains exposed to CO2 pricing, due to material coal-fired generation (2020: 28% of generation volume). CO2 prices have been rising since 2018, reaching EUR40 per tonne in March 2021. However, the negative impact is mitigated by the company's progressive reorientation into renewable generation and the long-term hedging policy. In our rating case, we assume coal's contribution to EBITDA to decrease to 3% over 2023-2024.

Low Leverage: Fitch applies nuclear-adjusted funds from operations (FFO) net leverage as a rating guideline for RWE, considering gross nuclear provisions and adjusting FFO for the nuclear provision utilisation, as due to the enforced phase-out the nuclear provisions will become due faster. We no longer capitalise leases and treat lease expenses as an operating expense.

We forecast nuclear-adjusted FFO net leverage to average 1.3x over 2021-2024. It should be close to zero in 2021, driven by large accumulated cash from the equity increase and compensation for the nuclear phase-out. The ratio increases to around 1.8x over 2023-2024 as we expect funds will be gradually spent. This is comfortably below the downgrade sensitivity of 2.5x. EBITDA should remain close to EUR3 billion, as renewables expansion compensates the drop in thermal contribution and our conservative assumptions on trading.

E.ON Stake Adds Flexibility: RWE has assigned its 15% stake in E.ON (BBB+/Stable), together with compensation from the government for the coal phase-out, to cover mining provisions. The value of the E.ON stake (around EUR3.5 billion) and the compensation (EUR2.6 billion) exceed the mining provision (EUR4.8 billion). This increases RWE's financial flexibility if it decides to divest the stake in full or in part.

Short-Term Disruptors: RWE managed the first year of the pandemic reasonably smoothly and did not encounter material problems in operations. There were only minor delays in commissioning new onshore and solar projects, mainly in the US. However, RWE's EBITDA in the onshore wind and solar division will be negatively affected in 2021 by around EUR0.4 billion due to the extreme cold in Texas in February and the need to buy the electricity that could not be generated internally. We treat these losses as one-off and non-recurring.

Feedback

DERIVATION SUMMARY

RWE is a generation-focused utility with a large conventional fleet. Due to the acquisition of the renewables portfolio from E.ON and innogy, and its organic expansion in this field, around half of RWE's EBITDA already originates from renewables.

RWE's business profile and debt capacity will likely evolve towards that of other generation-focused utilities with a high share of renewables in the portfolio such as Orsted A/S (BBB+/Stable), which has higher debt capacity due to a greater proportion of renewables, and Statkraft AS (BBB+/Stable).

The lack of regulated distribution or transmission business makes RWE's business profile weaker than that of German peer EnBW (BBB+/Stable), but its lower leverage means the credit profiles are aligned. RWE's credit profile is stronger than Fortum Oyj's (BBB/Negative) largely due to Fortum's acquisition of Uniper. Similar 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 electricity, coal and CO2 prices providing for stable results with an average EBITDA at EUR2.8 billion and average contribution from wind and solar at 62% over 2021-2023

- Capex at EUR11 billion cumulatively over 2021-2023, co-financed from disposal proceeds (mainly minorities)

- Dividends at EUR0.6 billion per year for 2021-2023

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

We currently do not anticipate an upgrade to the 'A' category. Upside is limited by RWE's business profile as an electricity generation utility with no networks, and coal among the main fuels over the rating horizon. However, signs of a quicker shift to renewables, e.g. over 50% capacity installed in renewables or over 75% contribution from quasi-regulated income to EBITDA, while keeping leverage low, could lead to positive rating action.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Feedback

- Deterioration of the business profile, e.g. due to delays in execution of investments in renewables, lower than expected profitability of new assets or economic downturn resulting in prolonged fall in demand for electricity

- Nuclear- adjusted FFO net leverage above 2.5x on a sustained basis

- Negative free cash flow after acquisitions and divestitures through the cycle

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

Healthy Liquidity: At end-2020, RWE's readily available cash stood at EUR9 billion, boosted by operating results and the equity increase. It also had EUR5 billion of committed and undrawn credit facilities.

Short-term financial liabilities at end-2020 amounted to EUR1.2 billion. Fitch calculates free cash flow after acquisitions and divestitures for 2021 at a negative EUR1.2 billion due to high capex.

As per our rating case RWE has healthy liquidity, sufficient for the rating horizon until 2024.

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SUMMARY OF FINANCIAL ADJUSTMENTS

At end-2020, Fitch applied a 50% equity credit to RWE's 2026 hybrid. From 2021 we do not apply equity credit neither to RWE's 2025 or 2026 hybrid due to their approaching call dates and our expectation that the company will give preference to senior unsecured debt in its capital structure.

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

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

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or 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

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RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
RWE AG	LT IDR	BBB+ Rating Outlook Stable	Upgrade	BBB Rating Outlook Stable

ENTITY/DEBT	RATING			PRIOR
	ST IDR	F1	Upgrade	F2
• senior unsecured	LT	BBB+	Upgrade	BBB
• subordinated	LT	BBB-	Upgrade	BB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Hybrids Treatment and Notching Criteria (pub. 12 Nov 2020)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 21 Dec 2020)

Corporate Rating Criteria (pub. 21 Dec 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

RWE AG	EU Issued, UK Endorsed

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Corporate Finance Utilities and Power Europe Germany

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