FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms RWE at 'BBB+'; Stable Outlook

Thu 15 Dec, 2022 - 6:41 AM ET

Fitch Ratings - Frankfurt am Main - 15 Dec 2022: Fitch Ratings has affirmed RWE AG's Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook. A full list of rating actions is below.

The affirmation reflects RWE's continuing strong position as a large generation company (genco) in Germany with exposure across western Europe and the US, its conservative market-risk positioning, improved business profile following its Consolidated Edison's (BBB+/Stable) clean energy businesses (CEB) acquisition and organic growth in renewables as well as the manageable impact of acquisition funding on its credit profile.

High electricity prices have benefited profits this year, albeit the contribution of quasi-regulated businesses to EBITDA is smaller as a result in the near term. RWE is also involved in the Germany's LNG infrastructure build-up through participation in two LNG terminals, although the financial impact on the company is limited. The Stable Outlook reflects our expectation that key credit metrics including nuclear-adjusted funds from operations (FFO) net leverage will remain within rating guidelines till 2025.

KEY RATING DRIVERS

CEB Acquisition Positive for Business Profile: We view the pending acquisition of CEB as positive for RWE's business profile as it would add around 3GW of solar capacity to RWE's total installed capacity of 38GW. The planned acquisition of CEB is part of RWE's "Growing Green" strategy, under which it intends to invest around EUR50 billion in its green core business to end-2030.

Target investments include wind farms, photovoltaic assets, battery storage, gas-fired power plants and electrolysers. This, along with organic growth in renewables and accelerated coal phase-out, is increasingly moving RWE towards long-term business sustainability. Typically, renewables businesses also provide longer term visibility on revenues and profits due to their long-term contracts with customers, which we assume to the case for CEB as well.

Boost to US Market Position: The CEB acquisition would improve RWE's geographical diversification, share of renewable technologies in the portfolio and the market position in the US. It would be in the top five renewables provider in the US, which would become the third-largest geography in installed capacity RWE after Germany and the UK. CEB also has a strong pipeline of projects in the US.

High Prices Benefiting EBITDA: We expect materially higher EBITDA for RWE (excluding the CEB acquisition) compared with our previous rating case. The company, as a large diversified genco, is benefitting from currently very favourable electricity market conditions, net of hedging and contracted generation. This upside is only partially limited by a price cap on the non-contracted renewables generation and expected normalisation of spark spreads for the gas fleet in the medium term due to RWE's pre-existing contracted positions.

Quasi-regulated Earnings Could Increase: We expect to see a higher share of quasi-regulated earnings following the CEB acquisition. However, due to ongoing market volatility, which has resulted in higher earnings from RWE's supply & trading business as well as merchant-exposed gas power plant generation, we expect RWE's share of quasi-regulated earning to remain similar to 2021's at below 40%. Over the medium-term growth in its renewables business and likely normalisation of gas prices should lead to an improvement of quasi-regulated earnings share (based on Fitch-calculated EBITDA).

Volatile Near-Term Free Cash Flow: We forecast free cash flow (FCF; after dividends, gross capex and variation margin-related cash flows) outflow of about EUR12 billion in 2022 and an inflow of about EUR8 billion in 2023. Most of this large year-on-year variation is the result of margin-related payments. In this respect, we assume that the stock of net margin receivables of almost EUR8 billion at year-end 2021 will be largely cashed-in over the forecast period in line with RWE's assumptions.

RWE's planned increase in gross capex on average of about EUR8 billion p.a. during 2024-2026, up from less than EUR5 billion p.a. during 2022-2023, leads to increasingly negative FCF from 2024.

Leverage to Increase: RWE's leverage is set to increase sharply as it funds the CEB acquisition with close to two-thirds debt. We forecast nuclear-adjusted FFO net leverage to increase to 2.0x in 2025, from 1.7x at end-2023 and 0.7x at end-2021. Leverage at end-2022 will be temporarily close to 3x due to the variation margin-related debt build-up. RWE's target leverage post 2025 has increased to 3.5x from 3.0x, which could translate into Fitch-calculated nuclear-adjusted FFO net leverage exceeding its negative rating sensitivity of 2.5x. This would have an adverse rating impact if not offset by a stronger business profile.

DERIVATION SUMMARY

RWE is one of the largest German utilities focusing on generation from both conventional and renewable sources. RWE's closest peers are European gencos like Fortum Oyj (BBB/Negative), Statkraft AS (BBB+/Stable), Orsted A/S (BBB+/Stable). RWE has a higher share of quasi-regulated business than Fortum, but remains more exposed to thermal generation, which implies a slightly lower debt capacity than that of its Finnish peer (on a standalone basis, ie. excluding Uniper).

The Nordic utility Statkraft benefits from its low-cost, flexible hydro-asset base and lower exposure to thermal generation, which is however offset by a lower proportion of quasi-regulated earnings than RWE's. The Danish utility Orsted has a greater proportion of renewables in its generation mix than RWE and benefits from long-term price support mechanisms from its offshore wind power business.

KEY ASSUMPTIONS

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

- EBITDA to increase significantly in 2022 due to higher electricity prices benefitting the non-contracted part of the business. EBITDA to decline in 2023 but to remain around 30% above 2021 levels

- Only contracted activity in CEB included in EBITDA calculation

- Cost of acquisition debt and all new debt at 7%

- Dividends, capex, CEB purchase price and disposals - all based on management forecasts

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, eg. over 50% capacity installed in renewables or over 75% contribution from quasi-regulated activity to EBITDA, while keeping leverage low, could lead to positive rating action.

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

- Deterioration of the business profile, eg. 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 FCF 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

Adequate Liquidity: At end-September 2022, RWE had EUR3.3 billion of cash and cash equivalents and EUR4.5 billion of marketable securities. In March 2022, RWE increased its available committed credit facilities to EUR8 billion from EUR5 billion. The credit lines include a EUR3 billion short-term tranche and two tranches (EUR3 billion and EUR2 billion) available until April 2026. This RCF is currently fully available.

In addition, RWE's 15% stake in E.ON (around EUR4 billion) increases its financial flexibility if it decides to divest the stake in full or in part. This compares with Fitch-projected FCF of negative EUR11.9 billion in 2022 (of which almost EUR9 billion relates to variation margin payments) and EUR7.8 billion in 2023, and no bond maturities in 2023.

ISSUER PROFILE

RWE is a power generation and trading company. It is one of the largest utilities in Germany with operations in several other European markets and worldwide.

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 an ESG Relevance Score of '4' for 'GHG Emissions & Air Quality' and 'Energy Management'. 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. Nevertheless, these factors have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

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.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
RWE AG	LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
	ST IDR	F1	Affirmed	F1
senior unsecured	LT	BBB+	Affirmed	BBB+
subordinated	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 28 Oct 2022) (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), v8.0.3 (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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