FitchRatings

FITCH RATES MOESK AT 'BB+'; STABLE OUTLOOK

Fitch Ratings-London/Moscow-09 August 2013: Fitch Ratings has assigned JSC Moscow United Electric Grid Company (MOESK) Long-term foreign and local currency Issuer Default Ratings (IDR) of 'BB+' and a Short-term foreign currency IDR of 'B'. The Outlooks on the Long-term IDRs are Stable.

MOESK's 'BB+' Long-term IDR includes a one-notch uplift reflecting moderately strong links with its majority shareholder, JSC Russian Grids, and indirectly the state. The company's 'BB' standalone rating is underpinned by its near monopoly position in electricity distribution market in Moscow and Moscow region, diversified customer base, outperformance of the set regulatory targets and sound credit metrics. One of the main constraining factors for the rating is the uncertainty and low predictability of the Russian regulatory framework. The company's exposure to volume risk, although not perceived by Fitch as high, is also a rating concern.

KEY RATING DRIVERS

Rating Incorporates Implied Support

Fitch incorporates a one-notch uplift in MOESK's 'BB+' Long-term IDR for implied parental support as we assess the overall strategic, operational and legal ties between the company and its majority-shareholder, JSC Russian Grids and ultimately the state, as moderately strong, according to the agency's Parent and Subsidiary Rating Linkage methodology. The relative strength of the strategic and operational ties is underpinned by MOESK's near-monopoly position in electricity distribution in Moscow and Moscow region and its sizeable contribution to the parent's EBITDA (42% in 2012).

Limited Legal Links

At the same time, we view the legal ties as limited as they lack financial guarantees, capital call arrangements or cross default provisions. Although the company has not received any tangible financial support (eg equity contributions) in the past given its strong financial profile, the track record of Russian Grids providing capital injections to its other subsidiaries and holdings demonstrates the parent's willingness to provide support if needed. MOESK is 51%-owned by Russian Grids, which is in turn 62%-owned by the Russian Federation (BBB/Stable).

Near Monopoly in Moscow and Moscow Region

MOESK's standalone rating of 'BB' is supported by the company's position as a near-monopoly electricity distributor in Moscow and Moscow region and its relatively good quality asset base compared with Russian peers. The company is responsible for around 87% of total electricity distribution market (by volume) in Moscow and 62% in the Moscow region. MOESK is also the largest regional distribution grid company in Russia based on the volumes of distributed electricity.

Another favourable aspect of the company's operations in the Moscow area is the fact that this is the most dynamically growing region of Russia in terms of electricity consumption and a relatively high income per capita compared with the Russian average, which should support consumers' purchasing power. Electricity consumption has increased at a 2.9% CAGR in Moscow over 2000-2012 compared to the average growth of 1.7% in Russia over the same period.

Weak Regulatory Framework

The uncertainty and low predictability inherent in the Russian regulatory framework for the electricity distribution networks is one of the main constraining factors for MOESK's rating. In our view, the revision of the RAB regulation (the RAB reload) undertaken soon after its introduction in Russia in 2011 undermines the underlying principles of the RAB regulation as well as stability and predictability of the regulatory environment necessary for long-term investments in the sector. We do not expect the RAB regulation to be fully abandoned, but it is likely to continue to be implemented only slowly (in those regions where it was maintained), at least in the medium-term, with less distinct differences from the indexation method.

Regulatory Uncertainty Within Headroom

While MOESK was the least affected by the RAB reload with limited amendments to its RAB targets and main parameters set for 2012-2017 compared with its peers, we believe these changes increased the uncertainty in the company's operations and, as a result, its cash flow risk. However, we view MOESK's currently strong financial profile (2012 funds from operations (FFO) gross adjusted leverage of 1.4x and FFO fixed charge cover of 11.8x) as a mitigating factor for the regulatory risk, which we perceive as high. We see headroom to absorb adverse regulatory changes within our forecast for MOESK. Although solid financials cannot fully offset all the uncertainties and unpredictability of the Russian electricity distribution regulation, they provide a degree of financial and operational flexibility for the company to adjust its strategy and investments to potential tariff cuts or other amendments by the regulator.

Volume Risk

Despite the positive volume dynamics over 2009-2012, the company is not immune from volume risk, particularly during the economic and/or financial downturn. While we do not assess the extent of this exposure as high, it still constitutes a rating concern. We believe this is mitigated by the fact that volume changes should be captured in the tariff dynamics, even if delayed to non-recessionary periods, as well as MOESK's diversified customer base and geography of operations. Steady demand was evidenced by a limited 2% yoy decline of its distributed volumes during the financial and economic crisis in 2009 followed by a quick rebound in 2010 (up by 4% yoy).

Outperformance of Operational Regulatory Targets

Should the RAB-related regime continue to be executed in the Russian electricity distribution sector, Fitch expects MOESK to continue largely outperforming the set operational regulatory targets (eg controllable OPEX, electricity losses, interruption rate) over 2013-2017. This is because at the initial stages of the targets implementation, the company has large headroom for efficiency improvement through cost cutting and technical upgrades and enhancements. We believe that the forecast good operational performance should underpin MOESK's credit profile and reduce the cash flow risk. This is important in the context of the Russian regulatory framework because, in contrast to some European regimes, it fully penalises the underperforming companies (without the limitation of the sharing factor) thus exacerbating the downside risk. Equally, it does not limit the upside potential allowing the outperforming networks to receive full rewards.

Diversified Customer Base

MOESK's business profile benefits from its relatively diversified customer base. Along with its geography of operations, this supports relatively good dynamics of its accounts receivable, the majority of which (around 82% in 2012) are not past due and the bad debt charge accounted for 6% of 2012 EBITDA. Fitch estimated the company's average accounts receivable days during 2010-2012 at 29 days, which places it at an advantage to Mosenergo (BB+/Stable) with the 2010-2012 average of about 44 days and Ventrelt Holding Ltd (BB-/ Stable) with 72 days average.

Sound Credit Metrics

The rating is underpinned by the company's solid credit metrics compared to international networks and Russian/CIS utilities. We forecast FFO gross adjusted leverage to increase to around 2.8x in 2014 from 1.4x in 2012 and FFO fixed charge cover to stay within 4x-6x over 2013-2015 (11.8x in 2012). The forecast deterioration of MOESK's credit metrics is driven by our conservative assumptions of the distribution tariff growth in line with Russia's inflation forecast by Fitch at 6% over 2013-2015, which is well below the level currently set by the regulator, and an expected drop in the connection fee revenue in 2013, which accounted for 34% of the company's 2012 EBITDA (FFO gross adjusted leverage was 1.96x at YE12, excluding connection fees from FFO). However, this does not materially undermine the company's positioning versus its peers. Despite a forecast decline of the operating cash flow in 2013 and the impact of the RAB reload in Russia, we expect MOESK to continue generating relatively stable cash flow over 2014-2015 similar to the international networks.

LIQUIDITY & DEBT STRUCTURE

We assess MOESK's liquidity position as satisfactory, with RUB8.3bn cash at end-2012 and uncommitted available credit lines of about RUB8bn (as of April 2013) more than sufficient to cover its short-term debt of RUB4.1bn. Most of the company's debt (71%) at end-2012 was long term, maturing in 2015-2017. The peak of debt repayment is expected in 2015 when RUB10.2bn of domestic bonds and RUB15bn of bank loans become due. The company plans to partly refinance these upcoming maturities with either a domestic or a Eurobond issue. Fitch forecasts the company to remain free cash flow negative over the next five years due to a sizeable capex programme of RUB236.5bn (USD7.9bn).

RATING SENSITIVITIES
Positive: Future developments that could lead to positive rating actions include:
- Improvement of the Russian regulatory framework for electricity distribution and track record of its stability and predictability.
- Evidence that the company can maintain its FFO gross adjusted leverage well below 2.5x and FFO fixed charge cover above 6x on a sustained basis would be positive for the standalone rating.

Negative: Future developments that could lead to negative rating actions include:
- Significant deterioration of the credit metrics on a sustained basis (FFO gross adjusted leverage trending towards 3.5x and FFO fixed charge cover below 4x) due to, for example, tariff growth below forecast inflation and/or persistent underperformance of the regulated operating expenses.
- Further material adverse changes to the regulatory framework.
- Weaker links with the parent and ultimately the state.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology', dated 5 August 2013, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715139