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Research Update:

Conexus Baltic Grid JSC Rating Affirmed at 'BBB+' On Strong Financial Performance; Outlook Stable

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Rating Action Overview

- Latvian gas transmission and storage operator Conexus Baltic Grid JSC (Conexus) managed to auction its gas storage capacity at high prices over 2022-2023, resulting in expected excess revenues of €42.6 million by April 2024, compared with the allowed regulatory return. We expect high auction prices will increase Conexus' revenues and EBITDA by more than €20 million annually over 2023 and 2024, compared with our previous base case, resulting in funds from operations (FFO) to debt above 40% over the next two years.
- Conexus submitted a proposal on the usage of the excess revenues that, if approved by the regulator, would enable Conexus to ensure stable EBITDA of about €25 million-€30 million and related FFO to debt of about 30%-35% from 2025 onward.
- We have therefore revised upward our assessment of the stand-alone credit profile (SACP) to 'bbb' from 'bbb-'.
- In addition, we no longer rate Conexus as an entity within Augstsprieguma tîkls AS (AST) but consider Conexus as a government-related entity because of its relationship with the Latvian government. This has no immediate impact on the 'BBB+' long-term issuer credit rating on Conexus.
- Our stable outlook reflects our expectation that Conexus' FFO to debt will peak at 40%-45% over 2023-2024 and remain comfortably at about 30%-35% from 2025 onward, well above the rating downside threshold of 25%.

Rating Action Rationale

Conexus will report strong results over 2023-2024, following the surge in demand for gas storage from 2022-2023. Latvian gas traders' demand for gas storage to ensure supply security in the region increased over 2022-2023. As a result, Conexus' revenues and EBITDA will increase by about €20 million-€25 million over 2023-2024, compared with our previous base case. This should result in S&P Global Ratings-adjusted EBITDA of about €50 million-€55 million over 2023-2024, from about €30 million in 2022. Excess revenues from the storage business should amount to about €40 million-€45 million by April 2024. Conexus has submitted a proposal to use half of its excess revenues for investments and half to stabilize tariffs for the upcoming regulatory periods. In addition, the removal of the €16 million guarantee related to the Poland-Lithuania pipeline (GIPL) from 2024 should contribute to lowering adjusted debt to €80 million-€90 million. This should lead to FFO to debt of about 45%-50% over 2023-2024 and 30%-35% thereafter. We expect Conexus' adjusted FFO to debt will be about 30%-35% once demand has normalized. This is well above the 25% downside threshold for the current rating.

Conexus operates under a regulatory framework we continue to view as mostly supportive, with the current tariff period ending in September 2025. New tariffs for gas transmission activities will be enforced in December 2023. They increased by 37% in nominal terms--27.5% in real terms, considering that we expect a rise in the consumer price index (CPI) by 9.5%--due to lower gas volumes over the last years. The real weighted average cost of capital (WACC), set in September 2022 at 2.72%, is applicable for the entire tariff period until September 2025, when the new regulatory period will start. Conexus also proposed to use half of the excess revenues accumulated from the storage activities to finance investments and half to stabilize storage tariffs for the current and the next storage regulatory periods (the latter starts in May 2026). We believe the regulated asset base (RAB) will remain stable at about €200 million-€250 million. Yet, it will be offset by the use of nominal WACC from 2026, which should increase the WACC in use by about 3%. The lack of a track record of the framework, however, constrains our assessment to "Strong/Adequate". For more details on the regulation in Latvia, please refer to "Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive," published Nov. 30, 2022.

Conexus benefits from an indirect support from the Latvian government, providing one notch of uplift to the SACP. We consider that Conexus plays a very important role for Latvia and the Baltics because it is the single gas transmission and storage operator (TSO) and it forms the common market area together with Finland and Estonia. We understand gas represents the major source of electricity production when commercially viable and district heating in Latvia. In addition, Conexus owns the only underground gas storage in the region, which has become more important in the context of the Russia-Ukraine war and gas supply issues. Our assessment of the moderately high likelihood of support is constrained by our assessment of Conexus link to the government. We assess this link as limited, mostly because the state has minority representation in the supervisory board. Out of the seven people composing the supervisory bord, the chair is a representative from the state and two members represent the state through the state's indirect majority holdings of AST. The moderately high likelihood of government support results in one notch of uplift of the issuer credit rating to 'BBB+'.

We no longer rate Conexus as an entity of AST. Despite AST owning 68.46% of Conexus, AST does not control Conexus because Conexus seven-strong supervisory council includes only two representatives of AST. This led us to consider Conexus an equity affiliate of AST. As a result, we do not rate Conexus as part of the wider AST group anymore. On the other hand, we understand that the Latvian government would support Conexus indirectly through AST if Conexus faced liquidity issues or distress.

Conexus' small size, compared with peers, continues to constrain the business risk profile. Conexus' reported annual EBITDA amounts to about €30 million, which is among the lowest among its rated peers. Considering the population size of Latvia however, Conexus' EBITDA is in line with that of its peer group in terms of network per inhabitant and EBITDA per inhabitant. However, we understand Conexus' growth is limited and its small scale could lead to a credit metrics volatility that exceeds that of its peers.

Outlook

The stable outlook indicates our expectation that Conexus' adjusted FFO to debt will remain at about 30%-35% over 2023-2025.

Downside scenario

A downgrade could stem from:

- Conexus' FFO to debt falling below 25%, without signs of recovery. This could result from the regulator not approving the usage of regulatory account as per Conexus' proposal, although this is not part of our base case;
- Increased liquidity pressure should Conexus be unable to maintain a liquidity ratio of at least 1.1x over the next 12 months; or
- A lower likelihood of support from the Latvian government.

A one-notch downgrade of Latvia would not result in a downgrade of Conexus.

Upside scenario

We could upgrade Conexus if it posts less volatile credit metrics, with FFO to debt remaining at about 30%-35%.

An upgrade of Latvia by at least two notches could trigger an upgrade of Conexus, although this is not part of our base case.

Company Description

Conexus is the natural gas transmission and storage operator in Latvia. Its operations are split evenly between transmission and storage activities.

- The 1,190-kilometer-long gas transmission network directly connects Latvia with Lithuania, Estonia, and Russia. Since April 2022, no Russian gas has been used in the Baltics, although the network transits through Russia en route to Kaliningrad.
- Incukalns is the only underground gas storage in the region, with a gas capacity of 46 terawatt hours (TWh), of which 22 TWh are cushion gas.

Established in 2017 after the unbundling of the Latvian energy sector, Conexus is now 68.46%-owned by AST (the electricity transmission system operator itself is 100%-owned by the state of Latvia) and 29.06%-owned by MM Infrastructure Europe, an infrastructure fund headquartered in Japan.

Our Base-Case Scenario

Assumptions

- Real GDP growth of 1.0% in 2023, 2.5% in 2024, and 2.8% in 2025; CPI growth of 9.5% in 2023, 3.5% in 2024, and 2.8% in 2025.
- Conexus' revenues include those from transmission and storage services.
- No Russian gas flows into Latvia since April 2022, which we view as having no impact on Conexus.
- Annual transmission revenues of about €25 million-€35 million over the new regulatory period.
- Significantly higher revenues of about €40 million-€50 million from the storage business over 2023-2024. We expect regulatory account of the storage business will reach about €40 million-€45 million as of April 2024. In our base case, Conexus can partially use this regulatory account to finance investments and maintain stable tariffs.
- EBITDA margins of 50%-60% over 2023-2025.
- Investments of about €150 million-€200 million over 2023-2027, of which EU funds will cover about 30%. About €30 million annually will be related to maintenance.
- Aggressive dividend policy, with a payout ratio of no less than 90% of net profit paid in the first half of each year. The dividend policy can be flexed if needed to ensure investments are made in time.
- Annual debt amortizations of €15 million-25 million.
- Support from AST in case of operational or financial distress.
- Annual loans contracted with the domestic bank, with an average interest rate of 4.5%-4.7%, provide liquidity support.

Key metrics

Conexus Baltic Grid JSC--Key metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2021a**	**2022a**	**2023e**	**2024f**	**2025f**
Revenue	56.4	55.1	75-80	75-80	65-70
Funds from operations (FFO)	30.6	29.4	45-50	40-45	25-30
Capital expenditure	27.6	17.8	30-35	40-45	25-30
Dividends	84.5	9.5	5-10	10-15	5-10
Debt	101.1	89.1	90-100	80-90	80-90
FFO to debt (%)	30.3	33.0	45-50	45-50	30-35

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Conexus' liquidity as adequate as of Nov. 30, 2023, and expect liquidity sources will cover uses by more than 1.1x over the next 12 months. While Conexus' liquidity position is currently tight, we note that the company has strong relationships with regional banks, as demonstrated with the annual extension of committed lines and the addition of bank loans.

Principal liquidity sources over the 12 months from Nov. 30, 2023, will include:

- Cash of €5 million-€10 million;
- About €45 million in bank loans that will be drawn before mid-2024 and will translate into additional cash;
- About €41 million in operating cash flows; and
- About €10 million-€20 million in EU funds.

Principle liquidity uses over the same period will include:

- About €13 million in debt maturities;
- A €10 million-€11 million in dividends to be paid in the first half of 2024; and
- Annual capital expenditure of €40 million-€45 million.

Covenants

Some of Conexus' credit facilities are subject to financial covenants, which we understand were fully met as of Nov. 30, 2023.

Conexus' debt covenants specify a maximum consolidated reported net-debt-to-EBITDA ratio of 5.0x, a minimum shareholder equity ratio of above 50%, and a debt service coverage ratio of at least 1.2x. In our base-case scenario, we expect the company will meet both covenants.

Environmental, Social, And Governance

Environmental factors are a moderately negative consideration in our credit rating analysis of Conexus. Similar to other gas utilities, we view the company's exposure to gas as moderately negative, considering the recent geopolitical development in Ukraine and the European pressure to reduce dependence on gas. However, we view Conexus as well placed to mitigate the pressure as the Baltics stopped receiving Russian gas on April 1, 2022, turning toward the U.S. and liquefied natural gas (LNG) imports through Lithuania's and Finland's LNG platform.

Ratings Score Snapshot

Issuer credit rating	BBB+/Stable/--
Business risk:	Strong
Country risk	Intermediate
Industry risk	Very low

Issuer credit rating	**BBB+/Stable/--**
Competitive position	Satisfactory
Financial risk:	Significant
Cash flow/leverage	Modest (medial volatility table)
Anchor	bbb
Modifiers:	
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb
Related government rating	A+/Negative/A-1
Likelihood of government support	Moderately high (+1 notch)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Tear Sheet: Conexus Baltic Grid, Aug. 1, 2023
- Latvia; June 19, 2023
- Industry Credit Outlook: EMEA Utilities 2023 Outlook: Eastern Europe: Credit Resilience Despite Increasing Affordability Concerns, Jan. 13, 2023
- Eastern European Utilities Handbook 2023, Jan. 5, 2023
- Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive, Nov. 30, 2022

Ratings List

Ratings Affirmed	
JSC Conexus Baltic Grid	
Issuer Credit Rating	BBB+/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.