Research Update:

ENGIE Rating Placed On CreditWatch Negative Amid COVID-19 Outbreak Due To Tight Financial Headroom And Governance Change

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Rating Action Overview

- Given a likely European economic slowdown in the context of the COVID-19 pandemic, we believe that ENGIE S.A.'s earnings could be pressured by lower contributions from its more cyclical Clients Solution business, and by lower power prices on unhedged positions growing from 2021.
- ENGIE's financial headroom has tightened following an acquisitive 2019 and upward revisions of its nuclear provisions. We believe that the group's current rating cannot withstand any operational underperformance without credit-protective measures.
- This is in the context of uncertainty around the group's strategic direction and organization, as the search for ENGIE's CEO's replacement started in February 2020.
- We are placing the 'A-/A-1' long- and short-term issuer credit ratings on CreditWatch with negative implications to reflect growing operating pressures at a time when the company's governance is more vulnerable.
- We plan to resolve the CreditWatch placement after we assess the extent of the downside risks and the group's action plan to counterbalance lower earnings prospects, and once we have evidence of its commitment to support credit metrics including FFO to net debt above 20%.

Rating Action Rationale

ENGIE had lower rating headroom before the start of the COVID-19 outbreak. ENGIE's 2019 results already reflected tight financial headroom following significant investments and capital deployed (€10 billion in 2019, including €1.5 billion to acquire 49.3% in Brazilian gas pipeline TAG). This translated in funds from operations (FFO) to net debt of about 19%, already below our 20% requirement for the current rating. In the context of possible lower earnings, and without credit protective measures, we believe it will be difficult for ENGIE to restore metrics above 20%, bearing in mind delayed investments will be mitigated by a potential halt in the disposal process (initially planned for a total of €4 billion from 2020-2022).

This comes on top of a change in governance that occurred on Feb. 6, 2020. In an extraordinary meeting, ENGIE's board of directors did not renew Isabelle Kocher's board mandate (which was due to expire in May), effectively ousting her as CEO. The move exposed, in our view, dissension and a lack of alignment between Ms. Kocher, the board, and its president, Jean-Pierre Clamadieu. It also cast uncertainty around the group's strategic direction and organization as the search for a replacement begins.

We expect ENGIE's earnings to be negatively affected by the looming global recession in its more cyclical Client Solutions business. We now forecast Europe to enter into a recession for the first half of 2020 (see "COVID-19 Macroeconomic Update: The Global Recession Is Here And Now," published March 17, 2020) and see economic risks rising for the following quarters, notably with a potential rapid appreciation of the euro and further economic slowdowns in other regions.

As a result, we forecast that ENGIE's Client Solutions business--still mostly exposed to Europe--may suffer from a significant reduction of its contracting base, especially in its asset-light services. We assess that both types of ENGIE's clients--industrial (about 27% of its portfolio) and public municipalities--will likely reduce discretionary nonprioritized spending, including on ENGIE's energy services. While we think the asset-based solutions are more resilient (longer-term contracts between 10 and 15 years, e.g. district heating and cooling infrastructures) ENGIE's growth over 2020-2022 will be driven primarily by asset-light energy services. While the economic situation is still evolving amid an undefined lockdown period, asset-light services, in the form of projects and recurring services, are more likely to suffer in our view from a prolonged economic slowdown because they are more cyclical. We are thus uncertain about the pace of a growth recovery after 2021 given the lack of clarity on the magnitude and length of the current outbreak.

ENGIE's generation and supply earnings will also be at risk for 2020 and 2021. We also expect ENGIE's generation and supply earnings to be negatively affected by lower electricity consumption in Europe (negative 5%-7% down in 2020 year over year), as well as weaker commodity prices driving lower power prices (negative 20% next year compared to our previous assumptions) will affect earnings on its unhedged outright production, hydro and nuclear, in France and Belgium.

EBITDA contribution of its supply business was already weak in 2019 (about €640 million, or 6% of the total group's EBITDA), primarily due to lower margins on gas and power retail for B2C clients as well as some one-offs in different geographies. We forecast a limited recovery from this low point due to weaker demand prospects.

In light of our revised power price forecasts in France and Belgium of €40 per megawatt hour for 2020 and 2021, and based on the current level of hedged of its outright production (about 58 terawatt hours) of 80% in 2020 and 54% in 2021, we assess a lower EBITDA of about €300 million, with a greater impact in 2021.

At this stage we forecast a power price recovery in 2022 driven by tight supply in neighboring countries and a drawdown of coal and nuclear capacities in Germany. If commodity prices remain depressed for longer, we would expect further EBITDA deterioration related to ENGIE's merchant-exposed generation.

We see some upward pressure on economic debt, with potential higher nuclear provisions delayed to next the triennial revision. Increasing pension and asset retirement obligation deficits may also affect ENGIES's economic debt as actuarial assumptions may increase liabilities. Given the existing Belgian regulation, we forecast that the group could face another material increase in its nuclear provisions in 2022, when next the triennial revision is due by the Belgian Nuclear Provisions Commission. ENGIE already faces an increase of €2.5 billion in its nuclear provisions in 2019 to €14 billion (see "Credit FAQ: Higher Nuclear Provisions And Lower Regulatory Returns: What Do They Mean For Engie S.A.?" published Dec. 20, 2019).

At the same time, we see additional risks any underperformance of planned assets (because of the significant decline in the stock markets over the past few weeks) offsets pension liabilities and, to limited extent dedicated assets offsetting nuclear liabilities, which could increase the deficit. More precisely, we see the current deficits widening for 2020 on increased pension liabilities and reduced fund performance, resulting in an increase of about €1 billion for 2020, with potential higher nuclear provisions delayed to 2022 (when the next triennial regulatory revision is due). These deficits, combined with lower earnings, could pressure further ENGIE's adjusted credit metrics.

Some mitigating factors will support ENGIE's cash flow. Engie's regulated infrastructure business provides some resilience to the group's earnings (39% of EBITDA in 2019) thanks to the essential service of transporting and distributing gas in France, and the regulated nature of its activities (network business).

On supply, in ENGIE's French market, we foresee working capital increasing as a result of extraordinary supportive measures announced by the government, including the postponement of gas and electricity bill payments. We recognize that working capital needs generally peak during the winter season and start to decrease as spring comes and payments are made. It is therefore likely that we will not see a major increase in debt over the coming months, but we also may not see the typical decrease at that time of the year. While temporary, this would be a negative for credit metrics and the recovery of the working capital outflows could take time. If the extent of this outflow becomes material, some governments may also provide some kind of support, including government-backed liquidity lines. Such measures have not been announced at this stage.

Supply chain disruptions could hurt the commissioning of renewable capacities and cause delays. While difficult to quantify at this time, we assess that it's currently marginal and thus manageable for ENGIE's earnings.

Growth capex cut could also provide some short-term relief. Lower investments will likely support credit metrics in the short term. Less activity from suppliers and reduced availability of staff and contractors due to forced containment will force utilities to focus on the most essential projects in Europe and postpone many of their discretionary projects. We believe this applies to ENGIE and that a complete revision of its growth capital expenditure (capex) plan is most likely as the group assesses the full impact of the outbreak on its different businesses. We also believe the lockdown will materially delay maintenance capex, most likely into 2021.

ENGIE continues to maintain an excellent liquidity position. ENGIE had a very comfortable liquidity position, with €10.9 billion of cash and equivalents at the end of December 2019, as well as €12.4 billion of committed undrawn credit lines, maturing beyond 12 months, that cover debt maturities beyond 2020. Amid volatile financial markets, ENGIE successfully issued a €2.5 billion multitranche bond with maturities up to 2032, with almost no impact on the average cost of debt to approximately 2.7%.

CreditWatch

The CreditWatch negative placement indicates that we could downgrade ENGIE if the group cannot provide clear remedy measures to address weaker credit metrics arising from lower earnings prospects amid the COVID-19 outbreak. We anticipate ENGIE will continue assessing the magnitude of the crisis on its business in the coming weeks. We will be monitoring the effectiveness of ENGIE's board to manage the current situation. Without proactive measures to support the balance sheet, including dividend reduction and hybrid debt issuance, we would consider lowering the rating.

Lower earnings prospects could materialize on the back of:

- Further evidence of Client Solutions contraction for a prolonged period.
- Reduced availability of its nuclear fleet due to unplanned outages.
- Greater-than-expected disruptions of its supply chain, lowering the group's renewables contribution.
- Higher working capital requirements resulting from the government's constraints on its supply activity.

We could affirm the rating if we gain comfort that the group will be able to restore adjusted FFO to net debt above 20% amid lower earnings prospects on the back of strong counterbalancing measures.

Company Description

With the disposal of its upstream activities in oil and gas exploration and production (E&P) and liquefied natural gas (LNG), ENGIE now has a strategic focus on power generation, gas infrastructure, and energy services. The group's strategic plan is to increase the share of long-term contracted energy activities, while maintaining a stable-to-increasing share of regulated business.

ENGIE notably operates the regulated French gas distribution and transmission networks, as well as downstream storage infrastructures. As of Jan. 1, 2019, the group had a total French regulated asset base of €28.2 billion (including the €3.7 billion storage assets regulated from Jan. 1, 2018) and €2.8 billion international gas and power networks. In addition, ENGIE had an installed generation capacity of 96.8 gigawatts (GW), or 53.9 GW in net ownership, of which about half is in Europe. The generation portfolio is mostly gas (47% on a net-ownership basis), hydro (21%), nuclear (11%), wind and solar (8% and 3%) and coal (4%). ENGIE also benefits from a large and broad customer base, including 6.8 million residential gas contracts (66.5% market share) and 4.3 million electricity contracts in France at end-2019. ENGIE is also a world leader in energy services, mainly through the Cofely brand. It generated over €1.8 billion of EBITDA in client solutions in 2019 and €600 million in supply.

ENGIE reported revenue of €60.1 billion and EBITDA of €10.4 billion as of Dec. 31, 2019. The company is listed on the Paris stock exchange and is part of the CAC 40, a benchmark French stock market index. It had a total market capitalization of about €25 billion as of March 24, 2020. The French state owns 23.6% of the company, and has held about 34.84% of the voting rights since April 2018.

Our Base-Case Scenario

Our base-case scenario is under constant revision as we continue to assess the impact of current economic conditions.

- Reported EBITDA to increase by 1.3%-1.5% in 2020 and 2021, compared with 2019, on the back of a COVID-19-related economic recession, with less contribution from Client Solutions, supply, and generation activities (versus previous expectations of 4-5%). From 2022, we forecast EBITDA growth back to 4.5%-5% supported by organic growth and tuck-in acquisitions in customer solutions and international networks.
- Stable cost of debt over 2020-2022 despite a slightly larger share of local debt in riskier countries.
- Marginal working capital movements in 2020 and 2021, as we currently expect the payment postponement to be recovered at year-end 2020.
- Investments (including tuck-in acquisitions) of about €4 billion-€5 billion over 2020-2022.
- In 2020, €2 billion-€3 billion of growth capex including the acquisition of EDP hydro assets for €650 million of net debt impact.
- Cash dividends of about €2.8 billion in 2020, in line with the dividend payout ratio guidance of 65%-75%, increasing with recurring net income thereafter.
- About €700 million of additional pension obligations linked to a lower interest rate environment.
- Weak performance of equity assets within dedicated assets of asset retirement obligations for a net debt impact of €200 million.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO of about €8.6 billion in 2020 and 2021, increasing to €9 billion and beyond from 2021.
- Adjusted debt decreasing to below €47 billion in 2020 and 2021 and increasing toward €48 billion from 2022.
- FFO to debt above 18% in 2020 and between 18.5%-19.0% in 2021-2022.
- Debt to EBITDA of 4.5x in 2020, decreasing toward 4.3x-4.4x on 2021-2022.

Liquidity

The 'A-1' short-term rating is supported by ENGIE's liquidity, which we still assess as exceptional. At Dec. 31, 2019, projected sources of funds exceeded projected uses by more than 2.2x over the next 24 months. Our assessment is further supported by the group's ongoing and proactive liquidity and debt management, solid relationships with banks, and ample and proven access to the capital markets, even under dire market conditions. The latter was reflected by the group's successful issuance of €2.5 billion on March 20, 2020, amid turbulence in the financial markets related to COVID-19 and the domino effect from the lockdown on the economy. Notwithstanding, given how quickly capital markets can change, this is an area we will continue to monitor closely.

Principal liquidity sources:

- About €10.9 billion in available cash and marketable securities at group level as of Dec. 31, 2019.
- About €12.4 billion in available committed credit lines maturing beyond 12 months, of which €5.5 billion and €5 billion related to two syndicated facilities maturing in 2022 and in 2025, respectively.
- Our forecast of unadjusted FFO of around €8.2 billion over the next 12 months.
- Issuance of €2.5 billion unsecured notes under its European medium-term notes program.
- No asset disposals in the course of 2020.

Principal liquidity uses:

- Long- and short-term debt maturities of about €7.1 billion, including €3.2 billion of outstanding commercial paper (debt maturities for 2021: €2.3 billion).
- Our estimate of gross capex (with some additional flexibility) not exceeding €5 billion in 2020.
- Dividend cash payments of about €2.8 billion (including dividends of the group's subsidiaries to minority shareholders).

Environmental, Social, And Governance

Following the sale and/or closure of nearly 60% of its coal-installed capacity since 2015, ENGIE is now in a better position from an environmental perspective and in line with its peers, with a relatively low carbon footprint. ENGIE's successful transformation includes the disposals of its oil and gas E&P and LNG businesses, stronger focus on renewables generation, and disposal of part of its European and international thermal generation assets--notably coal-fired plants. ENGIE has hence managed to reduce its carbon dioxide intensity from about 399 tons per gigawatt hour (GWh) in 2015 to 259 tons/GWh in 2018. However, the company's nuclear operations in Belgium pose several challenges related to the future of long-term nuclear waste storage, the government's decision to phase out nuclear power, and severe operational issues. In December 2019, ENGIE revised up by €2.5 billion its Belgian nuclear provisions to €14 billion following the review of the country's Nuclear Provisions Commission. This can be explained by an increase of about €1 billion for decommissioning provisions and about €1.1 billion for nuclear waste management. We have revised our forecasts accordingly, and our asset retirement obligations added to debt would increase to €12.1 billion in 2019 from about €9.8 billion in 2018. Furthermore, we believe the lack of visibility on the Belgian government's future energy policy will complicate the group's management of its nuclear fleet's withdrawal. ENGIE held an extraordinary board meeting on Feb. 6, 2020, and decided on the nonrenewal of the CEO's mandate, which was due to expire in May 2020. This dissension between the board and its current CEO might imply some uncertainty on the group's strategic direction and organization, although this change in ENGIE's executive management is intended to foster its transformation and should maintain its drive to boost renewable energies and client solutions. We will monitor the clarification of ENGIE's key growth pillars, although we acknowledge this will take some time after a new CEO is appointed.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- COVID-19: Coronavirus-Related Public Rating Actions On Non-Financial Corporations To Date, March 25, 2020
- COVID-19 Credit Update: The Sudden Economic Stop Will Bring Intense Credit Pressure, March 17, 2020
- COVID-19 Macroeconomic Update: The Global Recession Is Here And Now, March 17, 2020
- ENGIE SA's Good 2019 Operating Performance And Guidance Confirms Tight Financial Headroom, Feb. 27, 2020
- ESG Industry Report Card: Power Generation, Feb. 11, 2020
- Bulletin: ENGIE's Change Of Governance Creates Some Uncertainties About Strategic Direction, Feb. 10, 2020
- Credit FAQ: Higher Nuclear Provisions And Lower Regulatory Returns: What Do They Mean For Engie S.A.?, Dec. 20, 2019
- ENGIE SA, May 24, 2019

Ratings List

Ratings Affirmed; CreditWatch Action

	To	From
ENGIE SA		
Issuer Credit Rating	A-/Watch Neg/A-1	A-/Stable/A-1
GIE ENGIE Alliance		
Issuer Credit Rating	A-/Watch Neg/--	A-/Stable/--
ENGIE SA		
Senior Unsecured	A-/Watch Neg	A-

Ratings Affirmed; CreditWatch Action

	To	From
Junior Subordinated	BBB/Watch Neg	BBB
Commercial Paper	A-1/Watch Neg	A-1
GIE ENGIE Alliance		
Senior Unsecured	A-/Watch Neg	A-

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.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.