Research Update:

ENGIE SA Rating Lowered To 'BBB+' On Less-Resilient Business Amid Looming Recession; Outlook Stable

April 24, 2020

Rating Action Overview

- Given a sharper looming European recession amidst the COVID-19 pandemic, ENGIE SA's earnings (€10.4 billion EBITDA as of fiscal 2019) will likely decline due to weaker operating conditions in its Client Solutions and Merchant Power businesses, whereas we were expecting some growth before the crisis.
- S&P Global Ratings believes the dividend suspension in 2020 and some likely cuts in investments will not be enough to offset the resulting deterioration of ENGIE's credit metrics, which were already below our expectations at year-end 2019.
- We are lowering the long- and short-term issuer credit ratings to 'BBB+/A-2' from 'A-/A-1' and junior rating from 'BBB' to 'BBB-' to reflect growing operating pressures and the sustainably weaker credit metrics.
- Our stable outlook reflects our expectations that the group's earnings will progressively recover from 2021 and will be able to sustain credit metrics in line with the 'BBB+' rating, including funds from operations (FFO) to net debt staying sustainably within the 18%-20% range.

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Rating Action Rationale

ENGIE's earnings will likely be hurt by the looming global recession, notably in its more cyclical Client Solutions business. The outlook for the European economy has worsened over the past month, mainly because of stricter public health measures in many countries to contain the coronavirus. We expect countries with stricter lockdowns, more service-oriented economies (including France, Italy, and the U.K.) to suffer more despite the fiscal support announced by the respective governments. (For more information, see "Europe Braces For A Deeper Recession In 2020," published April 20, 2020, on RatingsDirect.)

As a result, we forecast that ENGIE's Client Solutions business--still mostly exposed to Europe and to the above-mentioned countries--is likely to suffer from a significant reduction of its contracting base, especially in its asset-light services. This activity represents less than 18% of the group's total EBITDA, but it was a material growth pillar over 2020-2022 (+5%-6% compound annual growth rate expected before the COVID-19 crisis) driven by a combination of organic growth, midsize acquisitions, and operating efficiency, all but the latter expected to be paused in 2020.

While withdrawing its 2020-2022 earnings guidance, ENGIE confirmed that the much-reduced activity in this division, reflecting lower commercial need and workforce restrictions, was one of the main impacts of COVID-19 containment measures. We assess that both types of ENGIE's clients--industrial (about 33% of its portfolio in turnover) and public municipalities--will likely reduce discretionary nonprioritized spending, including on ENGIE's energy services. Although we think the asset-based solutions are more resilient (longer-term contracts of 10-15 years, e.g., district heating and cooling infrastructures), we now anticipate ENGIE's asset-light energy services will only reflect a gradual recovery over 2021-2022.

Although the economic situation is still evolving amid an undefined decontainment process throughout Europe, in our view asset-light services, in the form of projects and recurring services, are more likely to suffer from a prolonged economic slowdown because they are more cyclical. We also believe the length of the crisis will determine the pace of the recovery. We are forecasting a longer-than-expected period during which commercial activity of ENGIE's clients will be halted or slowed (until the end of 2020). Nevertheless, we recognize that projects' backlog remain significant in Europe , that almost no contracts have been cancelled to date, and that ENGIE's industrial client base is diversified (with a focus on pharma and agro subsectors balancing construction and facility management). Finally, we do not anticipate heavy working capital deterioration risks for a large disciplined group such as ENGIE, nor a significant increase in bad debt provisions in its European markets at this stage.

All in all, we project ENGIE's reported EBITDA to decline by 6%-7% in 2020 (to €9.6-€9.7 billion compared to €10.4 billion reported EBITDA in 2019) and to progressively recover in 2022 at about €10.5 billion. We anticipate an EBITDA contraction for the Client Solutions' asset-light activities of about 30% in 2020 followed by a recovery of 15%-20% growth year-over-year in 2021.

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 decline as a result of lower electricity consumption in Europe (down 7% in 2020 year-over-year), as well as weaker commodity prices driving lower power prices (negative 20% next year compared to our previous assumptions), which 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 business-to-consumer 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 (MWh) for 2020 and €42/MWh in 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 €200 million-€250 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 limited decrease of economic debt conditional upon disposals, with potential higher nuclear provisions delayed to the next triennial revision. While we now forecast financial reported debt to be flat over 2021-2022 on the back of €1.9 billion cash savings resulting from dividend suspension in 2020 and successful execution of its disposal program , we still see some pressure on nonfinancial liabilities. Reported gross debt at year-end 2019 increased to €36 billion from €32 billion in 2018 due to the inclusion of operating lease liabilities into financial debt (IFRS-16 impact).

Increasing pension and asset retirement obligation deficits may also affect ENGIE's economic debt as actuarial assumptions may increase liabilities. We forecast the group could face another material increase in its nuclear provisions in 2022 (estimated to at least €1.5 billion in our base-case scenario), when the next triennial revision is due by the Belgian Nuclear Provisions Commission. ENGIE already faced an increase of €2.5 billion in its nuclear provisions in 2019 to €14 billion.

At the same time, we see additional risks in 2020 of underperformance of planned assets (linked to equity portion) offsets pension liabilities and, to limited extent dedicated assets offsetting nuclear liabilities, which could increase the deficit. More precisely, we expect current deficits to widen for 2020 on increased pension liabilities and reduced fund performance, resulting in an increase of about €1 billion for 2020. These deficits, combined with lower earnings, could further pressure ENGIE's adjusted credit metrics.

ENGIE's announced remedy measures for 2020 will not suffice to hold credit metrics in line with the 'A-' rating. In our base-case scenario, we now project ENGIE will post adjusted FFO to net debt below 20%, including in 2022, and consider this is commensurate with the 'BBB+' rating across our Utilities sector in Europe. ENGIE's adjusted FFO to debt was already weak for the rating at year-end 2019, at about 18.8%.

ENGIE suspended its 2019 dividends on April 2 and has launched operating expenditure optimization plans as well as revision of its investments program for 2020. However, we anticipate these credit protective measures, as material as they are, will not offset lower earnings prospects and are unlikely to support credit metrics in line with an 'A-' rating.

The dividend suspension will provide €1.9 billion of cash savings for 2020. In addition, we anticipate ENGIE will revise down its growth capital expenditure (capex) plan, and is likely to focus on most essential projects, constrained as well by the forced containment. We assess this cut could provide short-term relief of additional €1 billion on top of constrained maintenance capex, most likely postponed to 2021, leading to a reduction of about 20% for the current year. Finally, operating costs should be reduced thanks to temporary workforce unemployment ultimately covered by the French government. This should smooth profitability decline in the Client Solutions business and we incorporate these optimizations (estimated at about €150 million) in our EBITDA forecasts for the division.

Some mitigating factors will support ENGIE's cash flow and underpin the strong business risk profile. 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). We also view district heating and cooling concessions as providing cash flow visibility given the long tenor of these asset-based services.

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 in winter and start to decrease as spring comes and payments are made. It is therefore likely there will not be a major increase in debt over the coming months, but there also may not be the typical decrease at that time of the year. While temporary, this would be a negative for credit metrics (negative €500 million in 2020) and the recovery of the working capital outflows could take time. If the extent of this outflow becomes material, some governments may also provide 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 should not jeopardize target of 3 gigawatts (GW) additional capacity to be commissioned in 2020 and thus we view this as manageable for ENGIE's earnings.

While the board was swift to suspend dividends, future months will further test the effectiveness of ENGIE's governance. While we highlighted that ENGIE's governance was more vulnerable since the board ousted then-CEO Isabelle Kocher, we recognize that the current management/handling of the crisis from an operational and financial perspective by the triumvirate CEO prove effective. We will continue monitoring the effectiveness of ENGIE's board to manage the current situation, assessing the operational disruptions and financial consequence of the crisis, although we still believe there should be no strategic inflexion before the new CEO is nominated.

Outlook

The stable outlook reflects our expectations that ENGIE's operating performance will progressively recover over 2021-2022 and that credit metrics will improve, including our adjusted FFO/net debt remaining sustainably above 18%.

We anticipate the group will continue assessing the magnitude of the crisis on its business, and that will also shape the pace of its earnings recovery. At this stage, we do not factor any major deviation from the current strategy defined by the board and will reassess the strategic continuity once the CEO is in place.

Downside scenario

We could consider lowering the rating if the group was unable to sustain credit metrics in line with 'BBB+' requirements, including failing to achieve FFO to debt sustainably above 18%.

This could arise from a deeper-than-expected fall in earnings and profitability, reduced availability of its nuclear fleet due to unplanned outages, higher working capital requirements resulting from higher government-imposed constraints on its supply activity, and sharp increase of bad debt provisions. A significant debt-financed acquisition, notably in non-infrastructure assets, could also lead to additional negative rating pressure.

Upside scenario

We could consider revising the rating upwards, although unlikely in the short-term, when we gain visibility on the group's growth trajectory and if we see evidence of a successful repositioning on much less cyclical asset-backed Client Solutions. A clarification on the group's nuclear strategy in Belgium combined with reduced responsibility over nuclear liabilities could also prove beneficial to the group's credit quality. This would need to come with higher credit metrics, specifically with FFO to net debt trending comfortably above 20%.

Company Description

With the disposal of its upstream activities in oil and gas exploration and production and liquefied natural gas, 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 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 year-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 €640 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 €22 billion as of April 23, 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

Although under constant revision as we continue to assess the impact of current economic conditions, our base case includes the following S&P Global assumptions:

- In 2020, reported EBITDA to decrease by 6%-7% compared to 2019 (versus 4%-5% in our forecasts before COVID-19), on the back of expected economic recession, with less contribution from Client Solutions, supply, and generation activities. From 2021, we forecast EBITDA growth back to 2%-4% supported by rebound in Client Solutions and constant growth in renewable business.
- Stable cost of debt over 2020-2022 despite a slightly larger share of local debt in riskier countries.
- Working capital outflow of about €500 million in 2020, to be recovered partly in 2021, as we currently expect payment postponement to happen mainly in 2020.
- Total investments of about €10 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.
- Lower disposal than previously expected for 2020 to about €500 million, back to about €1.5 billion per year thereafter.
- Cash dividends of €800 million-€1 billion in 2020 including dividends for hybrids and minorities.

- About €700 million of additional pension obligations linked to a lower interest rate environment and funds performance
- 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 €8.2 billion in 2020 and €8.5 billion in 2021, increasing to about €9 billion from 2022.
- Adjusted debt kept stable to slightly decreasing at about €46 -€46.5 billion until 2022.
- FFO to debt around 17.5%-18% in 2020 and 18.5%-19.5% in 2021-2022.
- Debt to EBITDA of 4.6x in 2020, decreasing toward 4.2x-4.4x in 2021-2022.

Key metrics table

	2019A	2020E	2021E	2022E
FFO (Bil. €)	8.8	8.0-8.5	8.3-8.7	8.5-9.0
Adjusted debt (Bil. €)	46.9	46.2-46.7	45.2-46	45.5-46.5
FFO/debt (%)	18.9	17.5-18.0	18.5-19.0	19.2-19.5
Debt/EBITDA (x)	4.6	4.5-4.8	4.3-4.7	4.1-4.5

A--Actual. E--Estimate. FFO--Funds from operations.

Liquidity

The 'A-2' short-term rating is supported by ENGIE's liquidity, which we still assess as exceptional. As of Feb. 23, 2020, projected sources of funds exceeded projected uses by more than 2.2x over the next 12 months and over the subsequent 12-24 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.

Principal liquidity sources:

- About €11 billion in available cash and marketable securities at group level as of Feb. 23, 2020.
- About €11.8 billion in available committed credit lines maturing beyond 12 months, of which €5.5 billion and €5 billion relating to two syndicated facilities maturing in 2022 and in 2025 respectively.
- Our forecast of unadjusted FFO of around €8 billion over the next 12 months.
- Issuance of €2.5 billion unsecured notes under its European medium-term notes program.
- No further asset disposals in the course of 2020.

Principal liquidity uses:

- Long- and short-term debt maturities of about €7.8 billion, including €3.2 billion of outstanding commercial paper (debt maturities for 2021: €2.3 billion).
- Our estimate of gross capex (with limited flexibility) not exceeding €4.7 billion in 2020;
- Dividend cash payments of about €0.8 -€1 billion (including dividends of the group's subsidiaries to minority shareholders and hybrid debtors) in 2020.

Debt maturities

- 2020: €3.9 billion
- 2021: €2.3 billion
- 2022: €3.5 billion
- 2023: €3.0 billion
- Thereafter: €19 billion

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2019, ENGIE's capital structure comprises about €36 billion of senior unsecured debt and about €3.9 billion of hybrid securities unsecured debt issued by ENGIE SA and its financing subsidiaries. The group has debt of about €6.3 billion under local subsidiaries.

Analytical conclusions

We do not see any material structural subordination risk on the senior unsecured debt instruments issued by the group and rate them 'BBB+', in line with the issuer credit rating on ENGIE.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Strong

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

- Group credit profile: bbb+

Likelihood of government support: Low (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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 | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Credit Conditions: Rising Credit Pressures Amid Deeper Recession, Uncertain Recovery Path, April 22, 2020
- COVID-19: Coronavirus-Related Public Rating Actions On Nonfinancial Corporations And Affected European CLOs, April 17, 2020
- COVID-19: Coronavirus- And Oil Price-Related Public Rating Actions On Corporations,

Sovereigns, And Project Finance To Date, April 15, 2020

- Electricite de France S.A., April 3, 2020
- EMEA Utilities Should Withstand COVID-19 Better Than Most Sectors, March 24, 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

Downgraded; CreditWatch/Outlook Action

	To	From
ENGIE SA		
Issuer Credit Rating	BBB+/Stable/A-2	A-/Watch Neg/A-1
GIE ENGIE Alliance		
Issuer Credit Rating	BBB+/Stable/--	A-/Watch Neg/--
ENGIE SA		
Senior Unsecured	BBB+	A-/Watch Neg
Junior Subordinated	BBB-	BBB/Watch Neg
Commercial Paper	A-2	A-1/Watch Neg
GIE ENGIE Alliance		
Senior Unsecured	BBB+	A-/Watch Neg