MOODY'S
INVESTORS SERVICE

Credit Opinion: Lenenergo, JSC

Global Credit Research - 28 Feb 2014

St. Petersburg, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba2
NSR Corporate Family Rating -Dom Curr	Aa2.ru
Parent: Russian Grids, JSC	
Outlook	Stable
Corporate Family Rating	Ba1
NSR Corporate Family Rating -Dom Curr	Aa1.ru

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Key Indicators

Lenenergo, JSC[1]

	LTM H1 2013	12/31/2012	12/31/2011	12/31/2010	12/31/2009
FFO Interest Coverage [2]	3.8x	4.5x	3.1x	5.1x	5.1x
Net Debt / Net Fixed Assets	34.1%	31.1%	28.1%	21.8%	23.6%
FFO / Net Debt [2]	22.5%	28.9%	16.2%	38.1%	32.3%
RCF / Capex	0.5x	0.7x	0.3x	1.1x	0.9x
Debt / EBITDA	3.4x	2.8x	2.8x	1.5x	2.2x
EBITA margin	17.0%	17.9%	15.9%	22.6%	20.3%

[1] All ratios are calculated according to Moody's standard analytical adjustments, if not mentioned otherwise. [2] FFO figures incorporate a non-standard adjustment (reclassification of cash advances for network connections).

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Low level of predictability of the domestic grid sector regulation

Capped tariff growth under the Russian government's current policy orientation

Significant investment programme

Weakening economy and the risk of continuing decrease in electricity consumption

Some ability to adjust the investment programme in light of allowed tariff growth

A degree of state support from the company's shareholders

Corporate Profile

Headquartered in the city of St. Petersburg, JSC Lenenergo (Lenenergo) is one of Russia's major regional electricity distribution grid companies, focused on the St. Petersburg region (including the city of St. Petersburg and the Leningrad oblast). Lenenergo is a regulated natural monopoly, whose electricity transmission revenues accounted for around 75.1% of its 2012 total revenues of RUB38.1 billion, or around $1.2 billion (before normal technological losses). The largest shareholder of Lenenergo is state-controlled Russian Grids (Ba1 stable), which directly holds 53.41% and indirectly, through another subsidiary, IDGC of Urals (Ba2 stable), owns an additional 7.15% of Lenenergo's voting shares. A blocking stake of 26.57% of voting shares is owned by the government of the city of St. Petersburg (Baa1 stable).

SUMMARY RATING RATIONALE

Lenenergo's Ba2/Aa2.ru ratings incorporate: (1) the higher risk of the company's regulated grid business in Russia compared with the generally low business risk profiles of its peers in developed markets; (2) the company's financial profile and liquidity, which are pressured by its large investment programme; and (3) some degree of shareholder/state support available to Lenenergo given its advantageous shareholder structure and its strategic role in the economy of the St. Petersburg region, one of the wealthiest regions in Russia. The company's higher business risk is attributed to regulatory pressure and uncertainty facing the Russian grid sector. Moody's incorporates a one-notch uplift in Lenenergo's ratings for the support from its shareholders.

EVOLVING REGULATION IN RUSSIAN GRID SECTOR REMAINS KEY RATING CONSTRAINT

The evolving regulation of the Russian electricity grid sector is a key risk and a key component in determining the ratings of domestic grids, including Lenenergo, largely suppressing differences in rated grids' credit profiles. Electricity transmission tariffs remain subject to political considerations within the Regulatory Asset Base (RAB) model, which was introduced for the major part of the domestic grid sector in 2011 to improve transparency of tariff setting and attract investments to the sector but has not been consistently applied. Since early 2011, there have been continuous revisions of the regulation, driven by the government's efforts to cap electricity tariff growth for end users and support economic growth. The chain of revisions has culminated in the tariff freeze for 2014 and an inflation-linked tariff growth cap to be applied from 2015; the tariff freeze guidance relate to all natural monopolies. Under the tariff plans approved in 2012, tariff growth for grids was limited to 9.4%-10% from both 1 July 2014 and 1 July 2015; the September-2013 tariff freeze proposal implied no increase and a 4.8% growth cap, respectively, from these dates.

In December 2013, tariff decisions under the new tariff freeze guidance have been taken for the majority of distribution grids, including Lenenergo. We positively note that, in 2014, Lenenergo will continue to see a somewhat higher average tariff growth rate as an exception allowed by the regulators recognizing particularly low tariff increases for Lenenergo until 2012, the company's strategic importance and significant investment needs. However, in our view, these exceptional tariff decisions do not protect the company from the risk of increasing regulatory pressure and uncertainty facing all grid businesses in the weakening economic conditions.

LOWER INVESTMENT CAPACITY ASSOCIATED WITH LOWER TARIFF GROWTH IS LIKELY TO BE ADDRESSED WITH STATE SUPPORT

Lenenergo benefits from a higher-than-average tariff growth rate. However, the company's transmission tariffs remain insufficient to make the company profitable without getting an additional regulated revenue stream from connection charges (around 8% of H1 2013 total revenue) sourced mainly from new and/or expanding businesses. At the same time, the company's investment burden is higher compared to many other distribution grids. Similar to its domestic peers, Lenenergo remains challenged by inadequate through-tariff coverage for its large investment needs and dependent on the degree of linkage between tariff decisions and its investment programmes established by the regulators. Whether this linkage will be maintained has yet to be seen as investment programmes of Russian Grids' subsidiaries, including Lenenergo, are currently being reviewed with approval by the government expected by April 2014. We note that, while the majority of the subsidiaries are discussing a reduction of their investment programmes with the government, Lenenergo may even increase investments compared to its previous plan.

Overall, even if the degree of linkage between tariff decisions and investment programmes of Russian Grids' subsidiaries, including Lenenergo, were to weaken in the next 12-18 months, we would expect this to be temporary and to be at least partially compensated by state or state-related funding sources. Given the reduced capacity to fund investments from internally generated sources in the tariff-growth-capped environment, domestic grids have filled the funding gap mainly with debt finance. Owing to the evolving regulation, it would be difficult for grids to find investors other than the government. Lenenergo is among few distribution grids that received equity injections in the very recent past.

LARGE INVESTMENT NEEDS LEAVE THE COMPANY WITH LIMITED FLEXIBILITY

Lenenergo is challenged by a 2012-dated large investment programme for 2012-17 of around RUB87.9 billion ($2.5 billion), including VAT; with around two thirds of the investments having been scheduled for 2014-17. Currently, the programme is under review and likely to increase in the interests of economic development of the company's service region. Moody's understands that the government believes that the old asset base of the company, which suffered from underinvestment of the past, creates barriers for the development of the regional economy. As a result, Lenenergo's flexibility in delaying investments may be limited. Following an upward revision of its programme, we expect that the company will remain free cash flow (FCF) negative and exposed to significant execution risk.

WEAKENING ECONOMY MAY INCREASE REGULATORY PRESSURE AND AFFECT CASH FLOW GENERATION

Notwithstanding Lenenergo's strategic importance, we believe that the company remains exposed to the risk of government-initiated new tariff revisions in weakening economic conditions. New revisions may follow if the government's policy fails to encourage economic growth and electricity consumption, which decreased by 0.7% in 2013 in conjunction with a slowdown of GDP growth. As a result, given their outdated asset base, domestic grids, including Lenenergo, may have to face a wider funding gap between investment needs and internal cash generation sources. Though a reduction in electricity consumption in Lenenergo's service region is seen by regulatory authorities as attributable to a high degree to insufficient investments in the grid infrastructure, there is no certainty that infrastructure improvements will lead to higher consumption, particularly in the weakening economic environment of 2014.

FINANCIAL PROFILE REMAINS UNDER PRESSURE FROM SIGNIFICANT INVESTMENTS

Lenenergo's financial profile as of mid-2013 was more leveraged in comparison with those of similarly rated Russian peers, with debt/EBITDA having exceeded 3x. However, it remained broadly in line with the current rating, given cushion under interest and debt coverage metrics: in mid-2013, on a last-12-months basis, funds from operations (FFO) interest coverage was 3.8x and FFO/net debt was 22.5%. All metrics are calculated using Moody's adjustments.

We factor into Lenenergo's rating our expectation of a deterioration of the company's financial profile, owing to its significant investment programme and capped tariffs. Additional pressure may be created if connection charge proceeds appeared more volatile than expected in the weakening economy and, contrary to the government's expectation, Lenenergo's investments will not drive up electricity consumption in the region. In our view, depending on an increase of the investment programme, which is under discussion, the deterioration of the financial profile may even go beyond our guidance for the current rating, FFO Interest coverage of 3x and FFO/Net Debt in midteens. However, this is not our base case scenario for the company at the moment.

We currently expect Lenenergo to be able to remain in line with our current rating guidance in the next 12-18 months or to reasonably limit any deviation from the current rating guidance and restore its financial metrics shortly thereafter, based on the support from its major shareholders, the state-controlled Russian Grids and the government of the city of St. Petersburg. Both shareholders are expected to be able to (1) help the company adjust its investment plans to available funding and reasonably prudent leverage targets and also (2) facilitate its access to external funding to comfort its liquidity profile.

Liquidity Profile

Lenenergo's liquidity position remains dependent on its ability to attract reasonably in advance funding for its investment programme and maintain a long-term debt maturity profile. At the same time, being a monopoly business, Lenenergo is required to attract bank resources under time-consuming tender procedures, which may limit its flexibility in procuring additional liquidity. As it is not uncommon in Russia, Lenenergo's liquidity management policy has largely factored in its status of a state-related monopoly and established relationship with state-owned banks and does not necessarily require funding needs to be addressed far in advance.

In mid-2013, the company's liquidity position was stressed as Lenenergo violated covenants under a loan issued by state-owned Vnesheconombank and so early repayment may have been triggered. However, bank creditors, which are largely state-owned banks, were expectedly supportive, imposing no pressure on the company. Moreover, in October 2013, Lenenergo voluntarily paid up this loan and now has no financial covenants under its debt obligations. According to management's accounts, as of the beginning of 2014, Lenenergo has a long-term debt maturity profile, with short-term debt obligations accounting for less than 10% of its total debt and being covered by cash reserves and short-term deposits.

We acknowledge Lenenergo's good relationship with state-owned banks and expect the latter to remain supportive for the company. We understand that Lenenergo continues to negotiate long-term bank funding to facilitate its investments. We also positively note Lenenergo's access to domestic bond market: in 2012-13 Lenenergo placed two 3-yr domestic bond at the amount of RUB3 billion each. Overall, state-related shareholder support, which was particularly confirmed by 2012 cash equity injection, helps the company to mitigate pressure on its liquidity and financial profile from significant investments. In our view, the liquidity pressures are currently accommodated under the company's rating due to the support from shareholders.

Rating Outlook

The rating outlook is stable, as we believe that the company has sound and prudent plans to develop and adjust its business in close interaction with its shareholders taking into account the availability of funding, tariff evolution and the wider economic environment.

What Could Change the Rating - Up

Positive momentum for Lenenergo's rating could emerge if, in Moody's view, there were better visibility on the mid- to long-term evolution of its financial profile against the backdrop of the evolving regulatory environment and weak economic conditions. In Moody's view, the approval of Lenenergo's investment programme and government's funding for the company later this year could add clarity if these positive developments were not offset by a further weakening of the domestic economy and/or the company's weakening operating and financial performance.

What Could Change the Rating - Down

Moody's could downgrade the rating if negative pressure is exerted on the Russian sovereign rating. Negative pressure on the rating could also result from (1) signs of weakening support from the government; (2) a negative shift in the developing regulatory regime without compensatory measures by the state leading to significantly deteriorating margins; (3) pressured liquidity; (4) a failure of the company to manage its investment programmes in line with the tariff regulation and contain deterioration of their financial profiles, with FFO interest coverage and FFO/net debt falling materially and persistently below 3.0x and mid-teens, respectively.

Other Considerations

GRID-INDICATED ASSESSMENT

Moody's evaluates Lenenergo's ratings by applying the Rating Methodology for Regulated Electric and Gas Networks. Based on the company's historical financial performance, the methodology grid would map Lenenergo to a Baa3 category. Similar to other rated Russian electric utilities, the gap between the grid-indicated assessment and the actual rating incorporates a degree of uncertainty associated with the long-term evolution of Lenenergo's financial profile in the immature Russian operating environment. At the same time, pressured by the capped tariff growth and large investments, Lenenergo's financial profile is expected by Moody's to weaken in the next 12-18 months, though within the current rating. As a result, the gap between the grid-indicated assessment and the rating is likely to narrow.

Rating Factors

Lenenergo, JSC

Regulated Electric and Gas Networks Grid	**Current**		[3]**Moody's 12-18 Month Forward**

[1][2]	12/31/2012			View As of 1/19/2014	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)	**Measure**	**Score**		**Measure**	**Score**
Stability and Predictability of Regulatory Regime	B	B		B	B
Asset Ownership Model	Aaa	Aaa		Aaa	Aaa
Cost and Investment Recovery	Ba	Ba		Ba	Ba
Revenue Risk	Ba	Ba		Ba	Ba
Factor 2: Efficiency & Execution Risk (10%)					
Cost Efficiency	Ba	Ba		Ba	Ba
Scale and Complexity of Capital Programme	B	B		B	B
Factor 3: Stability of Business Model & Financial Structure (10%)					
Ability and Willingness to Pursue Opportunistic Corp. Activity	Baa	Baa		Baa	Baa
Ability and Willingness to Increase Leverage	Ba	Ba		Ba	Ba
Targeted Proportion of Op. Profit Outside Core Reg. Activities	Baa	Baa		Baa	Baa
Factor 4: Key Credit Metrics (40%) (3 Year Avg)					
(FFO + Interest) / Interest Expense (3-Year Average) [4]	4.2x	A		3.5x-4.0x	A
Net Debt / Fixed Assets (3 Year Avg)	27.0%	Aaa		50%-55%	A
FFO / Net Debt (3 Year Avg) [4]	27.1%	Aa		15%-20%	A
RCF / CAPEX (3 Year Avg)	0.6x	Ba		0.3x-0.5x	B
Rating: a) Indicated Rating from Grid b) Actual Rating Assigned		Baa3			Ba1 Ba2

[1] All ratios are based on 'adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations, if not mentioned otherwise. [2] As of 12/31/2012; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures. [4] FFO figures incorporate a non-standard adjustment (reclassification of cash advances for network connections).

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