MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Ceske drahy's Baa2 rating, outlook stable

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Paris, April 16, 2019 -- Moody's Investors Service ("Moody's") has affirmed the Baa2 long-term issuer rating and the senior unsecured ratings of Czech national railway operator Ceske drahy, a.s. ("CD" or "Ceske drahy"). Concurrently, Moody's has affirmed the ba2 company's baseline credit assessment (BCA), which is a measure of the company's standalone financial strength. The outlook remains stable.

'The affirmation of Ceske drahy's ratings and BCA reflects our view that following a strong operating performance in 2018 the company has built some headroom in the current rating category to raise debt to fund its increasing capital expenditure needs in the next 18-24 months', says Francesco Bozzano, AVP Analyst and lead analyst for Ceske drahy. "The expected increase in debt will push leverage (measured as Moody's adjusted (gross) debt/EBITDA) towards 5.5x over the next 18-24 months from 3.6x estimated in 2018, which remains within Moody's guidance for the current ratings", adds Mr Bozzano.

RATINGS RATIONALE

Ceske drahy's Baa2 issuer rating incorporates a three-notch uplift from the ba2 BCA, in accordance with Moody's rating methodology for government-related issuers. The uplift reflects continued strong relationship between the company and its sole shareholder, the Czech Republic, Government of (A1 positive).

CD's ba2 BCA is underpinned by the company's solid market position in the Czech Republic and high revenue visibility, owing to contracts that it has signed with the government and 14 municipalities for the passenger railway operations. Moody's expects the company to lose around 8% market share by 2020 as a result of the passenger railway market liberalization and to retain a solid market share well above 80% after 2020 as contracts are gradually tendered. The BCA also reflects the solid operating performance of the company owing to passenger and cargo traffic growth and the ongoing implementation of efficiency measures. CD's reported EBITDA margin should remain above 20% in the next 12 to 18 months despite some pressure coming from cost inflation and from future tenders.

The BCA is constrained by the expected negative free cash flows in the next 18 to 24 months driven by increasing capital expenditure needs. Capital expenditure will be mainly allocated to the modernization of the passenger and freight rolling stock, which will be key to ensure that CD will remain competitive. As a result, Moody's expects the company to raise additional debt, which will increase the company's leverage towards 5.5x. Given the fairly low gross leverage level of 3.6x estimated in 2018 and the expectation that the company will modestly grow its Moody's adjusted EBITDA, Moody's nevertheless expects the company to be able to maintain leverage within the guidance set for the current rating level.

Moody's acknowledges that the outcome of the competitive tenders and direct awards of contracts expiring in December 2019 resulted in a loss of market share for CD of around 8%, which is in line with Moody's and with the company's expectations. In the next three years, the risk of loss of market share will come from two contracts representing around 7% of the long distance market, expiring in 2021. While CD may lose more tenders going forward, Moody's expects the company to maintain a very strong market share of between 80% and 90% in the Czech passenger railway market.

Moody's expects the company's reported EBITDA margin to reduce to approximately 23% in 2020 from approximately 26% estimated for 2018. The temporary reduction during the period is a result of both the need to reallocate fixed costs to a reduced market share following the results of the recent tenders and to ongoing cost inflation, with CPI expected to grow by 1.9% in 2019 and 2.0% in 2020 in the Czech Republic. Moody's expects pressure on margins to be broadly offset by cost efficiency measures being implemented by the company such as the set-up of automatic ticketing and the reduction of maintenance costs as the rolling-stock is modernized. Moody's also recognises that inflationary pressures are partially mitigated by the indexation included in the company's contracts with public entities. As a result Moody's expects the company's EBITDA margin to remain comfortably above 20% beyond 2020.

Capital expenditure (capex) needs are expected to remain high until 2022, averaging CZK14 billion. Moody's expects the company to retain some flexibility in the execution of its capex plan with approximately CZK10 billion out the expected capex being optional and conditional on the successful disposal of assets, mainly land owned by CD. However, the increase in capex will put ongoing pressure on free cash flow, which will remain negative at least until 2022 as internal cash flow generation will not be sufficient to fund future capex needs.

The company's liquidity is underpinned by cash of CZK3.4 billion on its balance sheet as of the end of December 2018 and the company can count on CZK5.4 billion available under committed facilities, with maturities exceeding 12 months, and commercial papers, guaranteed by Czech banks, for CZK8.0 billion. Together with operating cash flow that Moody's forecasts at between CZK6.0 billion-CZK7.0 billion in 2019, the available liquidity will comfortably cover the expected capital expenditure of close to CZK12.5 billion; and debt repayments of CZK8.7 billion, including the EUR300 million bond due in July 2019. To strengthen its liquidity profile and its BCA, Moody's would expect CD to refinance its upcoming debt maturities well in advance of their due dates including the maturity of the EUR300 million bond coming due in July 2019.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that CD's leverage will remain within the Moody's guidance for the rating in the next 18-24 months despite the gradual increase in debt to fund increasing capital expenditure needs. The outlook also reflects Moody's expectation that CD will maintain a stable operating performance and achieve modest revenue growth despite the pressure coming from the passenger railway market liberalisation.

WHAT COULD CHANGE THE RATING DOWN/UP

Upward pressure on the rating would likely result from an upgrade of CD's BCA to ba1 from the current ba2, as a result of a sustainable improvement in the company's operating performance; EBITA margin remaining in the high single digits (in percentage terms), Moody's-adjusted debt-to-EBITDA ratio around 4.5x on a sustained basis, and free cash flow remaining positive on a sustained basis.

While linkages with the sovereign are deemed strong and an upgrade of the rating of the Czech Republic would be positive for CD's credit quality, it will unlikely result in an upgrade of CD's rating which is currently constrained by the ba2 BCA.

Downward pressure on the rating could arise if Moody's were to downgrade CD's BCA to ba3 from ba2 as a consequence of a weakening in the company's operational performance and/or credit metrics. In particular if Moody's-adjusted debt-to-EBITDA ratio increased and was maintained above 6.0x, free cash flow remaining negative for a prolonged period or in case of a deterioration in the company's liquidity profile. A downgrade of Ceske drahy's rating could also be triggered by a downgrade of the sovereign rating for the Czech Republic and/or a weakening of the close links between the company and its sole shareholder.

PRINCIPAL METHODOLOGY

The methodologies used in these ratings were Global Passenger Railway Companies published in June 2017, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

Ceske drahy, a.s. is the national railway operator in the Czech Republic. The company is mainly engaged in passenger and freight transportation and associated activities. Ceske drahy is 100% controlled by the Czech Republic. In 2017, CD recorded total revenue from principal operations of CZK34 billion (€1.4 billion, in line with 2016), of which around 65% was from passenger transportation and around 35% from freight transportation.

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