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13 January 2022

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FIRST READS

Rains disrupt Brazil iron ore operations, risking production and increasing safety concerns

Originally published on 11 January 2022

On 10 January, Vale S.A. (Baa3 stable), Companhia Siderurgica Nacional (CSN, Ba2 stable) and Usinas Siderurgicas de Minas Gerais S.A. (Usiminas, Ba2 stable) all announced that they had curtailed some iron ore operations following sudden, heavy rainfall in Minas Gerais, Brazil's second-largest iron ore-mining state, on 8-9 January. The production shut-ins and heightened safety risks are modestly credit negative for Vale, CSN and Usiminas, but prolonged flooding that disrupts mining and logistics operations for an extended period would likely reduce their production volumes and therefore hurt cash flow and revenue more significantly.

Heavy rainfalls also aggravate environmental, social and governance (ESG) risks for producers, particularly environmental risks related to waste and pollution, including tailings dams, and physical climate risk, which raise the risk of lasting credit implications for issuers including reputational risks.

The production disruptions could imply a short-lived boost for iron ore prices worldwide, given that Brazil produces roughly 20% of global supply, and extended production disruptions would likely reverberate in commodity prices worldwide. Our view for iron ore prices remains unchanged for 2022, at an average $100/ton, lower than in 2021 but still at historically elevated levels. Producers face lower steel output in China amid environmental controls, weakening property construction market and energy pressures in manufacturing.

Vale on 10 January said it had halted production in its Southern system in Minas Gerais and at its Brucutu and Mariana complexes in its Southeastern system – partly to protect employees from dangerous commutes – but that its Northern system operations would continue. The company also said it had halted freight rail service for its Southeastern and Southern systems. Considering Vale's total iron production from January through September 2021, the company's Southern system accounts for around 18% of its total iron production, with the Southern system generating about 22% of the total, and the Brucutu and Mariana complexes account for roughly 60% of production at the Southeastern system. Regular operations have continued in the Northern system, where Vale produces 60% of its total annual iron ore volumes and for which it reaffirmed its annual production guidance of 320-335 million tons in 2022.

CSN said it had temporarily suspended extraction and movement operations at its Casa de Pedra mine and stopped iron ore loading operations at its port terminal Terminal de Carvão-TECAR in Itaguaí, Rio de Janeiro state. CSN's steel operations are running normally. Casa de Pedra has a total annual production capacity of 30 million tons of iron ore and accounts for the bulk of CSN's iron ore sales of around 34 million tons in the 12 months ended September 2021. CSN's iron ore subsidiary accounts for roughly 50% of the company's total revenue and 60% of its EBITDA. Despite its importance to CSN, a short-lived interruption in its iron ore business does not harm the company's credit quality because CSN built a significant liquidity buffer in 2020-21 to withstand short-term volatility in its operations.

Usiminas announced a temporary suspension of operations at its Mineração Usiminas (MUSA) mining subsidiary because of rainfall significantly above the historical average in the Itatiaiuçu region of Minas Gerais. Usiminas said it would reopen its MUSA mines once it determined it could do so safely and that MUSA's suspension of operations were not affecting its supply of raw materials to the parent company's steel operations. MUSA has an annual iron ore capacity of 9 million tons, of which around 6.5 million tons is sold to third parties. Usiminas' mining business accounts for around 20% of its consolidated revenue and any short-term interruption to operations would not significantly hurt Usiminas' overall credit metrics, which are also stronger than historical levels based on the recent strength of the steel and iron ore industries.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Brazil's ongoing drought has heightened the risk of flooding conditions, with much of the country's soil unprepared for such heavy rainfall in a short period, and Vale and Usiminas both noted on 10 January that they were closely monitoring their tailings dams. Usiminas activated level 1 of the Emergency Action Plan for Mining Dams for its central dam; level 1 means an initial state of alert and does not represent a compromise in the dam's safety factors or require the relocation of residents from risk areas. CSN activated level 2 of the Emergency Action Plan for its B2 tailings dam, located in Rio Acima, Mina Gerais; level 2 means that the dam requires new inspection because of a non-controlled or non-extinct anomaly.

According to CSN, the B2 tailings dam does not present risks to the local population because residents in risk areas have been relocated, and the dam does not materially change the company's production levels. A tailings dam run by French steelmaker Vallourec overflowed on 8 January, shutting down an interstate highway while also heightening broader environmental and social concerns. Thirty-six dams in Minas Gerais are reportedly under at least level 1 of the Emergency Action Plan for Mining Dams.

Click here for the full version of the report.

Barbara Mattos, CFA, *Senior Vice President*
Moody's Investors Service
barbara.mattos@moodys.com
+55.11.3043.7357

Marcos Schmidt, *Associate Managing Director*
Moody's Investors Service
marcos.schmidt@moodys.com
+55.11.3043.7310

Carolina A Chimenti, *Vice President - Senior Analyst*
Moody's Investors Service
carolina.chimenti@moodys.com
+55.11.3043.7318

China's tightening regulation of financial leasing companies' SPVs is credit positive

On 7 January, the China Banking and Insurance Regulatory Commission (CBIRC) published detailed rules on the management of project subsidiaries known as special purpose vehicles (SPVs) for CBIRC-regulated financial leasing companies.[1] The new rules took effect the same day. SPVs refer to subsidiaries the financial leasing companies set up to conduct specific leasing projects or financing activities.

The implementation of the new rules is credit positive because it will tighten the supervision of such SPVs and strengthen risk management within the financial leasing sector.

These measures will help simplify the organizational structure of financial leasing companies and in turn reduce operational risks. The new rules require financial leasing companies to centralize and consolidate risk management of SPVs and prohibit them from having a separate management team for single vehicles.

The new rules also specify that financial leasing companies should prudently contain the number of such subsidiaries, refrain from having multiple tiers of subsidiaries and liquidate idle subsidiaries that have not conducted tangible leasing businesses or financing activities for more than six months. The regulatory update also caps the total capital of a financial leasing company's SPVs at 50% of the group's consolidated net assets.

Additionally, the new rules explicitly define the offshore funding and investing vehicles that the financial leasing companies have been using as "managerial project subsidiaries." Leasing companies can, through their specialized subsidiaries,[2] maintain up to three such funding vehicles offshore. However, the total amount of outstanding bond payables at these platforms should not exceed five times the specialized subsidiary's consolidated net capital.

We expect the new requirement to encourage leasing companies to issue debt offshore through centralized financing platforms, such as that of Bocom Leasing Management Hong Kong Co Ltd (BLMHK, A3 stable), rather than through single SPVs, leading to a simpler issuance structure, a credit positive. This will most affect leasing companies such as China Development Bank Financial Leasing (CDB Leasing, A1 stable) and CCB Financial Leasing Corporation Ltd. (CCB Leasing, A1 stable) that currently issue offshore debt through SPVs (such as CDBL Funding 1 and CDBL Funding 2) guaranteed by specialized subsidiaries with operating assets and supported by keepwell deeds from onshore parent companies.

The CBIRC allows financial leasing companies to establish SPVs either directly or through their specialized subsidiaries located in tax-free and free-trade zones in China. The main purpose of an SPV is to segregate risk across leasing projects and contain tax and funding expenses.

According to the China Banking Association, there were 68 financial leasing companies in China as of year-end 2020. Examples of rated financial leasing companies include ICBC Financial Leasing Co., Ltd. (A1 stable), CDB Leasing, CCB Leasing, Bank of Communications Financial Leasing (A2 stable), CMB Financial Leasing Co., Ltd. (A3 positive), China Merchants Commerce Financial Leasing (Baa2 stable), Minsheng Financial Leasing Co., Ltd (Baa3 stable), and China Huarong Financial Leasing Co., Ltd. (Baa3 review direction uncertain).

The exhibit summarizes the key rules that the CBIRC is tightening. The new rules replace the CBIRC's previous measures issued in 2010.

Summary of key tightened rules

	New rules	Previous rules
Shareholding requirement	Require 100% shareholding by leasing companies	None
Permitted leasing asset type	Expand to include container, heavy equipment, and vehicle	Aircraft, shipping, marine engineering equipment and other equipment-type asset approved by the CBIRC
Centralized risk management framework	1) Require centralized and consolidated risk management framework; 2) Prohibit separate management team for single SPVs	None
Number of SPVs	1) Each SPV can have multiple underlying leasing contracts as long as the lessee is the same; 2) Require leasing companies to prudently control the number of SPVs; 3) Prohibit establishment of shell SPVs without underlying leasing contracts; 4) Mandatory liquidation of SPVs that have been idle for six months	Each SPV is allowed to have only one underlying leasing contract
Layers of SPVs	Cap at one layer for onshore SPVs and two layers for offshore SPVs	None
Maximum capital	Cap the sum of SPVs' capital at 50% of a leasing company's consolidated net assets	None
Requirement on offshore financing vehicles ("managerial project subsidiaries")	1) Allow specialized subsidiaries to set up managerial project subsidiaries offshore that are specifically for financing and investing; 2) Cap the number of such financing subsidiaries at three; 3) Cap the outstanding amount of bond payables of financing vehicles at five times of specialized subsidiaries' consolidated net capital	None

Sources: China Banking and Insurance Regulatory Commission and Moody's Investors Service

Endnotes

1 Financial leasing companies refer to the leasing companies approved and regulated by the CBIRC as nonbank financial institutions.

2 Specialized subsidiaries refer to entities that operate specific financial leasing businesses in the free-trade zones and tax-free zones in China or abroad. The CBIRC implemented the concept in 2014.

Lan Wang, CFA, *AVP-Analyst*
Moody's Investors Service
lan.wang@moodys.com
+852.3758.1621

Sophia Lee, CFA, *Associate Managing Director*
Moody's Investors Service
sophia.lee@moodys.com
+852.3758.1357

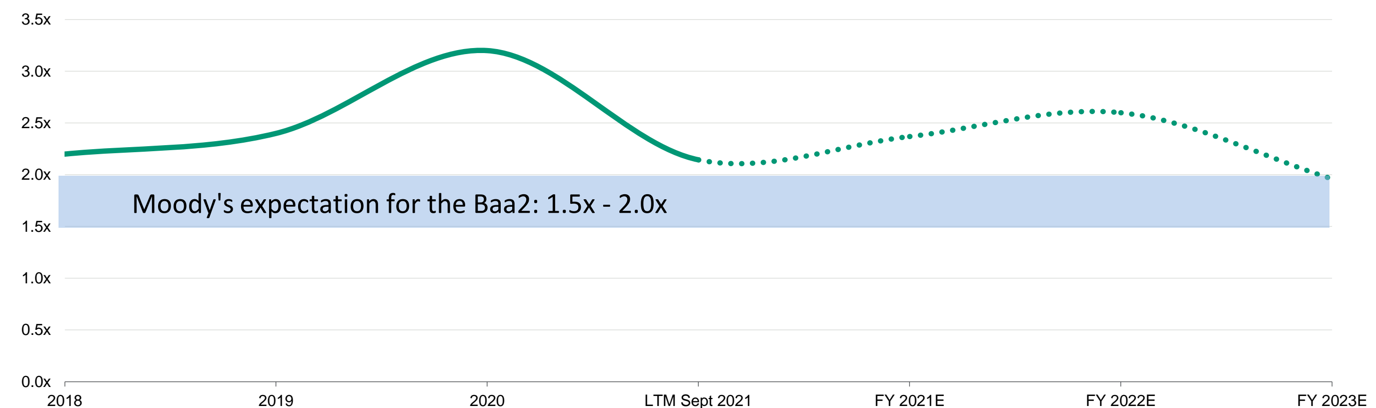
Aptiv's acquisition of WindRiver will increase leverage, a credit negative

Originally published on 11 January 2022

On 11 January, automotive parts supplier Aptiv Plc (Aptiv, Baa2 stable) announced the acquisiton of the software company WindRiver for $4.3 billion. Aptiv will finance the acquisition price with a mix of cash and debt, so its leverage will increase and temporarily exceed our quantitative expectations for the Baa2 rating, a credit negative. However, we expect leverage to be back in line with our expectations by 2023. As such the rating and stable outlook are unaffected.

Upon the transaction's close, we expect that the company's Moody's-adjusted debt/EBITDA ratio will exceed our quantitative guidance of 1.5x-2.0x for a Baa2 rating through this year at least (see exhibit). However, with a continued recovery of global light vehicle sales (see our automotive sector outlook published December 2021), Aptiv's continued growth over market, and the company's free cash flows being largely used for debt reduction, we expect leverage to come down to around 2x by the end of 2023.

Aptiv's leverage will temporarily increase because of the WindRiver transaction, but should restore to a level commensurate with the Baa2 in 2023
Moody's-adjusted debt/EBITDA



Acquisition of WindRiver expected to be closed mid-year 2022; assumed to be financed with 50% debt and 50% cash on hand
Sources: Moody's Financial Metrics and Moody's Investors Service estimates

WindRiver offers edge-to-cloud software for intelligent connected systems. Founded in 1981, the company generated approximately $400 million of revenues in 2021 and had an EBITDA margin in excess of 20%. The company's main markets are aerospace and defense (45% of revenue), industrial and medical (30%) and telecom (15%). Automotive accounts for 10% of revenue, essentially in the area of operating systems and over-the-air (OTA) software updates.

Software systems are a major area of investment for automakers (original equipment manufacturers or OEMs), as connectivity, autonomous driving and infotainment systems grow rapidly in new vehicles. While many OEMs, especially in the premium segment, are spending high amounts on research and development to invest in own vehicle software systems, some OEMs with tighter investment budgets or less scale instead will procure partial or entire software systems externally. With the acquisition of WindRiver, Aptiv will expand its existing complementary smart vehicle architecture (SVA) platform for electrical and electronical systems within its Advanced Safety & User Experience segment (AS&UX; $3.6 billion of net sales in 2020, representing 27% of Aptiv's group sales) and can participate in this fast-growing market segment.

The transaction price is high, at approximately 11x revenue in 2021, reflecting the high growth rates and strong profitability of a software company. The transaction is expected to be closed by mid-year 2022. Aptiv will finance the transaction through a combination of cash and additional debt. At the end of September 2021, the company's cash balance amounted to $2.7 billion,

which included still-unused proceeds from a $2.3 billion equity increase in June 2020. We assume that additional debt will contribute approximately half of the transaction price, with the remainder being cash.

Matthias Heck, CFA, *VP-Sr Credit Officer*
Moody's Investors Service
matthias.heck@moodys.com
+49.69.70730.720

Falk Frey, *Senior Vice President*
Moody's Investors Service
falk.frey@moodys.com
+49.69.70730.712

S M Naimul Haque, *Associate Analyst*
Moody's Investors Service
smnaimul.haque@moodys.com

SIG Combibloc acquires Evergreen Asian fresh cartons business, improving Asia-Pacific footprint

Originally published on 07 January 2022

On 5 January, SIG Combibloc Group AG (Ba1 stable) announced that it ha agreed to acquire Pactiv Evergreen Inc.'s Asia Pacific Fresh operations for $335 million. The acquisition will comprise 7% of revenue on a pro forma basis and will be debt financed. The companies expect the acquisition to close in the second or third quarter of this year, subject to customary closing conditions.

We believe that the transaction will give SIG an opportunity to advance its growth strategy in a number of important APAC countries, particularly China, and capitalise on the strong demand for fresh milk in these markets. SIG will also be able to take advantage of complementary technology and drive further development with its innovation capabilities.

At the same time, the debt-financed acquisition is likely to raise SIG's leverage slightly and marginally reduce its free cash flow generation. Still, we expect SIG's leverage to remain below 4x as measured by debt/EBITDA and its free cash flow/debt to be close to 5%, in line with our quantitative rating guidance.

Pactive Evergreen's Asia-Pacific operations supply filling machines, cartons, closures and after-sales service. The target business focuses on the fresh segment, mainly milk, and is a leading supplier in mainland China, which contributes approximately 50% of its revenue, with the remainder coming largely from South Korea and Taiwan. There are production facilities serving each of these markets.

The company expects the target business to generate revenue of around $160 million in 2021 and an adjusted EBITDA of around $28 million. SIG expects to improve on Pactiv Evergreen's profitability through a board supply arrangement for coated carton board, as well as cost synergies.

The transaction is being financed with a bridge loan with a maturity of up to 18 months that the company expects to replace with long-term debt in the capital markets.

Maria Maslovsky, *VP-Senior Analyst*
Moody's Investors Service
maria.maslovsky@moodys.com
+44.20.7772.5502

Mario Santangelo, *Associate Managing Director*
Moody's Investors Service
mario.santangelo@moodys.com
+44.20.7772.5222

Fire at Berlin production site will potentially reduce ASML's revenue growth in 2022

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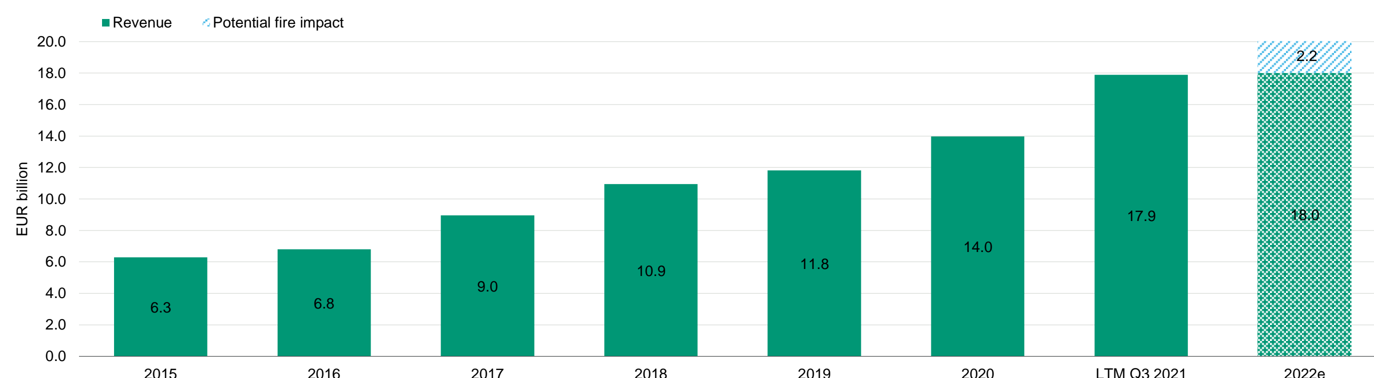
On 7 January, ASML Holding N.V. (A2 stable) provided further information about the extent of a 3 January fire at a Berlin production site, stating that the fire had affected a production area of modules used to produce the company's extreme ultraviolet light (EUV) lithography systems, ASML's core product.

The event is credit negative for ASML because it potentially reduces the company's production capacity and risks leading to lower revenue growth in 2022 albeit the full impact needs to be determined. However, ASML's rating remains unchanged because the company is strongly positioned in the A2 rating category and we expect the negative effects of this production interruption to be temporary. Our growth expectations remain high over the next 2-3 years because of high demand and the company's strong market position. ASML's credit quality benefits from strong underlying profitability, modest leverage and strong free cash flow generation.

Initially, we expected under our base case that ASML would sell close to 50 EUV systems this year. The fire incident might delay the production of EUV systems and, thus, we now expect ASML to sell 42-45 systems in 2022. Based on the average price per EUV system of around €150 million as of the last 12 months to September 2021, we estimate the total revenue effect will be up to €1.2 billion plus lower-than-expected installed base management sales. Such a scenario would reduce revenue growth in to low-single digits in percentage terms from our earlier estimate of 9%. However, there is the potential that a newer version of the EUV systems introduced in 2021 and selling at higher average prices will mitigate the effect of fewer sales.

ASML generated a revenue of €17.9 billion in the 12 months that ended September 2021 (see Exhibit 1), up 30% compared to the same period in 2020, supported by an increasing share of its EUV systems and higher installed base revenue. Revenue from EUV systems accounted for around 33% of ASML's total revenue in this period, with the company selling 39 systems.

Exhibit 1
The effect of the fire has the potential to lead to slower growth in 2022
Revenue per year

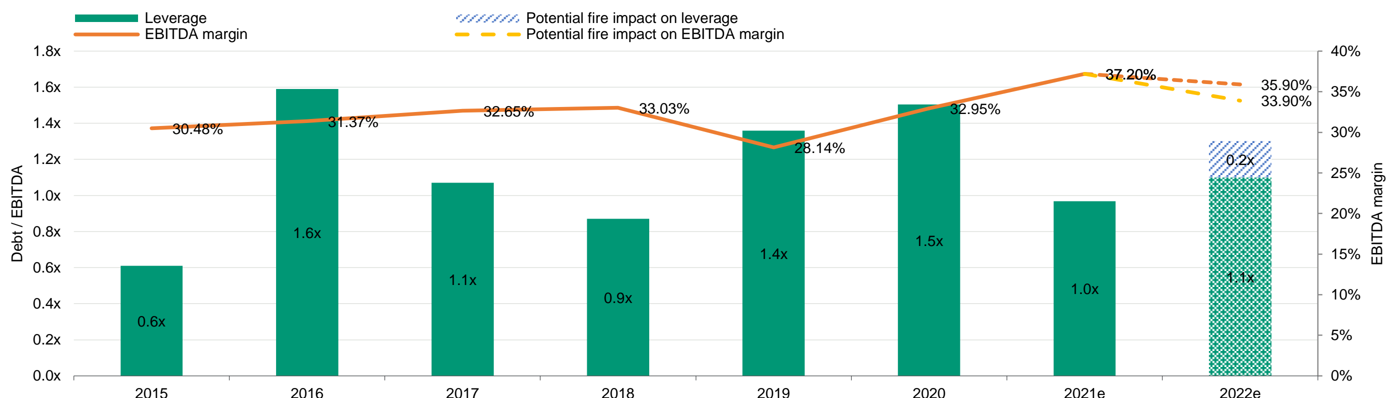


Forward view based on Moody's expectation.
Sources: ASML and Moody's Investors Service

We expect ASML to maintain its strong profitability, with EBITDA margins (Moody's-adjusted) well above 30%. Moody's-adjusted debt/EBITDA might increase by 0.2x to 1.3x in 2022 in our base case (see Exhibit 2) and remain well within the required guidance for the A2 rating category. Free cash flow is also likely to decline, but will still be strong at €2.1 billion. Additionally, the company has high flexibility in the execution of its share buyback program to support liquidity, if needed.

Exhibit 2

Lower revenue and EBITDA will lead to slightly higher leverage in 2022



Forward view based on Moody's expectation.
Sources: ASML and Moody's Investors Service

Apart from the direct effect on ASML, a reduction in production capacity negatively affects the capacity of its customer base as well, especially given that ASML has a de facto monopoly for EUV lithography systems. Many semiconductor companies have announced plans to expand capacity amid strong demand and high utilization of semiconductor production capacity. The high demand, which among other things is driven by secular trends such as high chip content in the automotive industry or consumer electronics, led to supply shortages in 2021 and we expect this situation to persist this year.

Dirk Goedde, *AVP-Analyst*
Moody's Investors Service
dirk.goedde@moodys.com
+49.69.70730.702

Christian Hendker, CFA, *Associate Managing Director*
Moody's Investors Service
christian.hendker@moodys.com
+49.69.70730.735

Indonesia's temporary coal export ban highlights regulatory risk for miners

Originally published on 12 January 2022

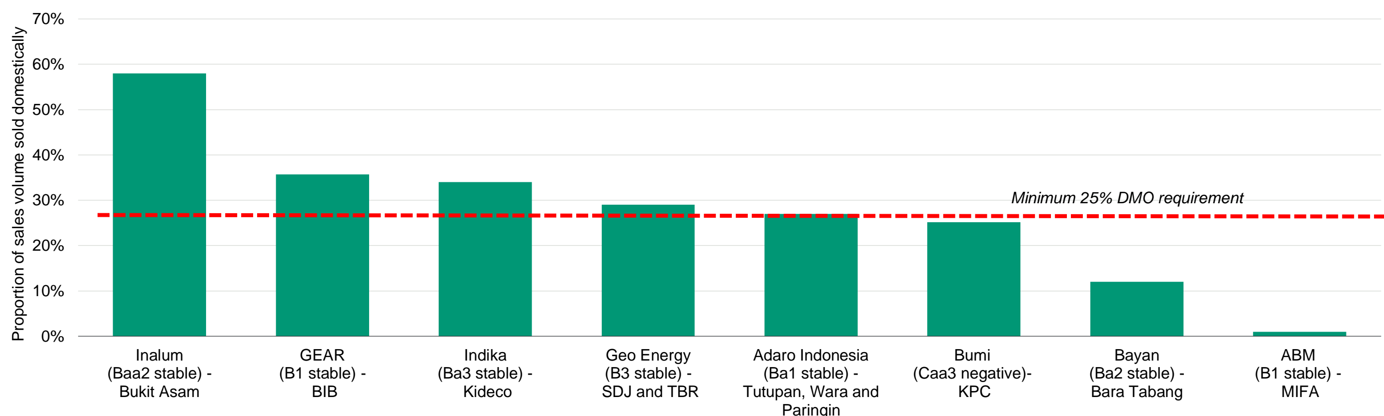
As of 12 January, Indonesia's (Baa2 stable) Ministry of Energy and Mineral Resources (MEMR) had yet to confirm when it would lift its conditional one-month ban on coal exports. The ministry had previously said that it would evaluate the ban after 5 January once domestic power plants had secured sufficient coal supply to prevent electricity outages.

While it will not immediately weaken the credit quality of the affected miners we rate, the industrywide export ban is credit negative because it highlights the evolving regulatory uncertainty for the sector. The unexpected blanket export ban applied to all miners including those that had complied with Indonesia's Domestic Market Obligation (DMO) regulation, which requires coal miners to sell at least 25% of their domestic coal sales volume domestically.

The ban, which was enforced to prevent a domestic coal supply shortage, also highlights the rising risks for two of the eight Indonesian miners we rate that are unlikely to have met the minimum domestic coal sales regulation in 2021. Key mines for Bayan Resources Tbk (P.T.) (Ba2 stable) and ABM Investama Tbk (P.T.) (B1 stable) had domestic coal sales volume below the 25% level mandated under the DMO regulation (Exhibit 1).

Exhibit 1

Domestic coal sales for Bayan and ABM's key coal mining subsidiaries are below the regulator's minimum requirement of 25%



Data represent sales volume for the nine months ended September 2021 for all miners except Bumi, whose data is estimated for the full year ended December 2021.
Sources: Company filings and Moody's Investors Service estimates

Sanctions from the mining regulator, such as prolonged export bans or large fines, should they occur, could weaken these companies' credit metrics. Bayan is less vulnerable than ABM because it has a higher proportion of domestic coal sales at its key mine and a stronger credit profile, including a larger cash balance and no debt.

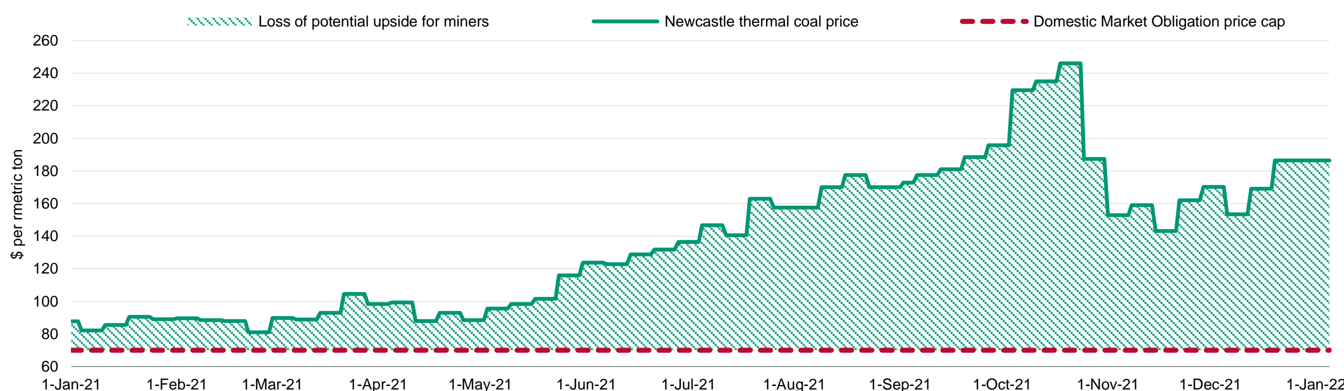
Despite meeting all its domestic contractual sales obligations, Bayan has only sold 10-20% of its coal volume domestically in recent years, below the 25% DMO requirement. The company has sought to address its domestic sales volume shortfall by paying a penalty of $1.0-1.5 per ton of coal, based on penalty rates calculated by MEMR in 2020. However, MEMR has yet to announce revised penalty rates for 2021. Bayan has also signed contractual commitments with domestic customers to be able to meet the 25% DMO requirement in 2022 at its two largest mines, Bara Tabang and Fajar Sakti Prima, which represent 80-90% of its annual coal production.

ABM's key coal mining subsidiary PT MIFA Bersaudara (MIFA), which contributes around 70% of ABM's annual coal production, sells very little coal domestically. This is because coal produced at MIFA is of lower calorific value and its specifications are not favored by domestic power plants in Indonesia, and is therefore exported primarily to India (Baa3 stable).

The ban is also credit negative for Indonesia's coal mining industry because it will temporarily limit earnings growth for all miners. This is because Indonesian coal miners could export their coal at a current market price that is around 2.5x the price cap on domestic coal sales to electric utilities (Exhibit 2).

Exhibit 2

Price cap on thermal coal sales to domestic electric utilities limit the potential upside for miners

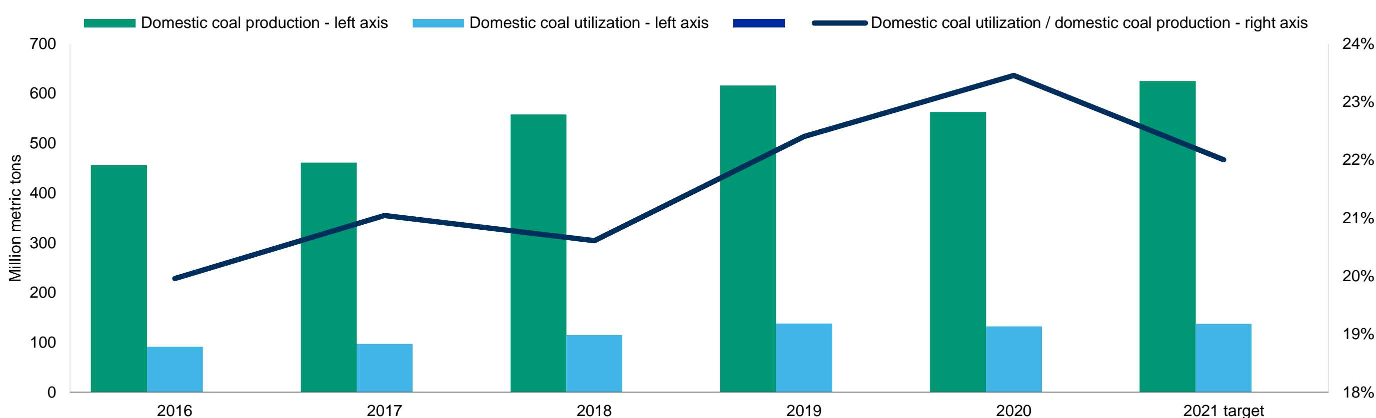


Source: Bloomberg

However, notwithstanding these negatives, we do not expect a prolonged industrywide export ban because Indonesia's annual domestic coal utilization has represented only around 20-23% of domestic coal production. The country's annual coal production target for 2021 of around 625 million metric tons far exceeds domestic coal utilization of around 138 million metric tons (Exhibit 3).

Exhibit 3

Annual domestic coal utilization represents 20-23% of domestic coal production



Source: Indonesia Ministry of Energy and Mineral Resources

Therefore, while rated miners will experience lost earnings in January, they could make this up in subsequent months once the export ban is lifted. These miners can also still generate a profit, although lower, if they sell coal domestically at the price cap.

We do not expect miners to experience large financial penalties from customers due to delayed or canceled export sales in January to the extent that they can seek contractual relief under force majeure provisions in their customer contracts. For example, Bukit Asam (P.T.) Tbk, the coal mining subsidiary of Indonesia Asahan Aluminium (Persero) (P.T.) (Baa2 stable) stated in a stock exchange filing

that the coal export ban is deemed a change in law and therefore meets the condition for it to declare force majeure on its customer contracts. As such, it will be relieved from all obligations under its coal sales agreements during the force majeure period.

Maisam Hasnain, CFA, *VP-Senior Analyst*
Moody's Investors Service
maisam.hasnain@moodys.com
+65.6398.8325

Anthony Prayugo, *Associate Analyst*
Moody's Investors Service
anthony.prayugo@moodys.com
+65.6398.8331

Ian Lewis, *Associate Managing Director*
Moody's Investors Service
ian.lewis@moodys.com
+65.6311.2676

Veolia's acquisition of SUEZ is credit positive

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On 10 January, Veolia Environnement S.A. (Baa1 stable) announced that the group holds 86.22% of the capital of SUEZ (Baa1 stable) following its cash tender offer. The acquisition is credit positive because Veolia will benefit from markedly increased scale and geographic diversification, while a series of measures have been implemented to cushion the strain on financial metrics.

We affirmed Veolia's ratings in July 2021 after the SUEZ board recommended acceptance of Veolia's offer[1] and we continue to expect that the group will restore financial flexibility to levels commensurate with a Baa1 rating by year-end.

With the somewhat complementary geographies of the two groups, the acquisition enlarges Veolia's international presence, especially in Europe (excluding France) and the Americas, in the context of rising competition in a highly fragmented market, and accelerates the ongoing shift toward offering more sophisticated environmental solutions (focus on hazardous waste) and efforts to increase barriers to entry. There is an unchanged primary focus on water and the waste businesses, supplemented with energy services. The combination creates the leading group in waste and water activities globally, with revenue of over €37 billion and EBITDA of close to €6 billion. Over 80% of revenue is derived outside France. In 2020, Veolia reported €26 billion revenue and €3.6 billion EBITDA.

Since announcing its initial acquisition of 29.9% of SUEZ's capital in October 2020, Veolia's management has acted in accordance with its stated commitment to maintain credit quality. Over 2020-21, the group increased its capital by €2.5 billion and issued €2.5 billion of hybrid bonds to partially fund the transaction. In addition, in October 2021, Veolia signed an agreement with SUEZ and a consortium of financial investors to sell SUEZ's French water and waste assets, some of its unregulated municipal water operations outside France, as well as global digital and environmental activities for a total consideration of €10.4 billion (see Sonate Bidco: New issuer – Assignment of first-time issuer rating, 19 November 2021). The transaction is expected to close by the end of February.

Veolia's management has also committed to additional disposals, including mostly hazardous waste and industrial water businesses in France, to comply with European Antitrust Authorities' requirements. Finally, Veolia plans additional cost savings building to €500 million in 2025 from operational synergies and savings on general expenses, including procurement.

The European Commission approved the SUEZ acquisition on 14 December 2021, subject to the disposal of SUEZ assets to Sonate Bidco and the above-mentioned additional remedies. Veolia also received clearance from all other antitrust authorities without any further required disposal, excluding that previously agreed with Australian company Cleanaway with regard to waste assets (landfills, transfer stations and a few other minor assets) in the Sydney area. The sole exception is the UK Competition Market Authority, whose approval is expected by the end of the first half of 2022, with the authority still investigating to assess necessary remedies, if any.

Veolia intends to reopen its offer from 12 January to 27 January, which will be followed by a squeeze-out of remaining shareholders should its ownership in SUEZ exceed 90%.

Endnotes

1 **"Communiqué de réponse OPA" as of 29 June 2021**.

Celine Cherubin, *VP-Sr Credit Officer*
Moody's Investors Service
celine.cherubin@moodys.com
+33.1.5330.3366

Aurore Haas, *Associate Analyst*
Moody's Investors Service
aurore.haas@moodys.com
+33.1.5330.3397

Neil Griffiths-Lambeth, *Associate Managing Director*
Moody's Investors Service
neil.griffiths-lambeth@moodys.com
+44.20.7772.5543

Zhejiang Provincial Energy's listed power subsidiary issues profit warning for 2021, a credit negative

On 8 January, Zhejiang Provincial Energy Group Co. Ltd's (ZEG, A1 stable) listed power subsidiary, Zhejiang Zheneng Power Co., Ltd. (Zheneng Power) issued a profit warning on the Shanghai Stock Exchange, announcing that it will post a net loss of approximately RMB760 million-RMB1.14 billion for year ended 31 December 2021. This compares with a net profit of RMB6.086 billion for the same period a year ago. The expected net loss is caused by a significant surge in coal prices in 2021 that is not fully compensated by the prevailing coal power tariff, despite strong power demand growth amid continuing economic recovery following disruptions caused by the coronavirus pandemic 2020.

Zheneng Power's profit warning for 2021 is credit negative for ZEG because it could result in the group's leverage – as measured by funds from operations (FFO)/debt – continuing to weaken. The likely increase in leverage is because Zheneng Power holds most of ZEG's thermal power generation capacity, and is a major revenue and profit contributor to the ZEG Group, with 48% and 74% of the group's consolidated revenue and net profit in 2020, respectively. We expect ZEG's FFO/debt to weaken to below our previous expectation of around 16% and the downgrade trigger of 15%.

However, we expect ZEG's financial performance to recover in 2022 because the Government of China (A1 stable) implemented measures in the fourth quarter of 2021 to support the coal-fired power sector, including coal power tariff reform, promotion of coal production and supply, along with coal production cost investigation and price supervision. Accordingly, the spot thermal coal price, measured by Bohai-Rim Steam-Coal Price Index, had dropped by around 14% by the week of 5 January 2022 from its peak in October 2021.

Meanwhile, the implementation of a new coal power tariff mechanism will lead to higher possible realized tariffs for the coal-fired power generators and will relieve the sector's profitability pressure amid high coal prices. Since the National Development and Reform Commission's (NDRC) announcement regarding the coal power tariff reform, more than 10 provinces, including Zhejiang, Guangdong, Jiangsu, Henan and Shandong, among others, have announced tariff increases.

Moreover, we expect that ZEG's strategic importance to the government and its likelihood of receiving government support will remain high because the expected loss is also the result of ZEG's public policy function to secure the power supply for Zhejiang province, which further tightens the link between ZEG and the government. For the first three quarters in 2021, Zheneng Power's total thermal power dispatched grew 35.2% year on year growth.

Nonetheless, any continuing failure to pass through the coal price hikes or any significant aggressive debt funded capital investment will likely result in ZEG's financial metrics remaining below its downgrade trigger for a sustained period, which will exacerbate pressure on the company's credit profile.

Qingqing Guo, ***AVP-Analyst***
Moody's Investors Service
qingqing.guo@moodys.com
+86.21.2057.4093

Nicole Gu, ***Associate Analyst***
Moody's Investors Service
nicole.gu@moodys.com
+852.3758.1545

Ning Loh, ***Associate Managing Director***
Moody's Investors Service
ning.loh@moodys.com
+852.3758.1668

ESG 2022 outlook: amid new pledges, action on carbon, social issues will come to the fore

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» **Limits of decarbonisation commitments heighten focus on physical climate risk.** Commitments announced during last November's United Nations Climate Change Conference (COP26), though encouraging, still put the world on track for an estimated rise in global temperatures of between 1.8 and 2.4 degrees Celsius by the end of the century. Global warming on this scale would expose more than a billion people to dangerously high temperatures and accelerate sea level rise with credit implications for many sovereigns especially in emerging markets. For the private sector, inherent exposure to physical climate risk is high across multiple industries according to our analysis. Growing awareness of these potential consequences is making investors more mindful of the implications of physical climate risk.

» **Credit implications of carbon transition risk will become increasingly evident.** Governments, financial institutions and companies made a series of pledges before and during COP26, which increased momentum toward a more rapid energy transition than previously expected. The Glasgow Financial Alliance for Net Zero (GFANZ), which is seeking net-zero commitments from financial institutions, could have particularly significant implications. If GFANZ members follow through on their commitments, it will increase pressure on carbon-intensive sectors and companies without credible carbon transition strategies because their access to capital will tighten. We expect this momentum to continue to seek to close the significant remaining gap between COP26 commitments and ambitions to limit temperature rises to no more than 1.5 degrees Celsius.

» **Natural capital and water stress risk will continue to rise in prominence.** Investors will increasingly focus on natural capital and biodiversity, which are also inextricably linked to climate change but have not been as closely considered by financial markets. An important milestone will be the planned finalisation in May of the Convention on Biological Diversity's global biodiversity framework, which aims to put biodiversity on a path to recovery by 2030 at the latest. The nascent Taskforce on Nature-related Financial Disclosures (TNFD), which aims to publish a framework for disclosures on nature-related risk by 2023, is likely to act as a catalyst for more consistent inclusion of nature-related risks in financial analysis.

» **Initiatives to expand ESG disclosures will increasingly address social considerations.** The global push for improved corporate disclosures about ESG considerations will continue to spotlight environmental risk, while policy initiatives and added disclosure obligations will also increase attention on social considerations, including human rights, labour issues and gender and racial diversity. New sustainability disclosure rules, board diversity listing requirements and investor initiatives regarding executive compensation and shareholder voting will continue to be proposed or implemented across various markets.

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For oil and gas firms, market rebalancing will persist in 2022; focus on energy transition slowly picking up

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- **The global energy industry will continue to rebalance in 2022 in step with the ongoing recovery in demand for energy, which will exceed pre-pandemic levels by the end of 2022.** Rising uncertainty about the expansion of oil and gas supplies will continue to support oil prices at the higher end of our medium-term oil price range of $50-$70/barrel (bbl), and high natural gas prices will persist as the global industry resolves significant ongoing dislocations. While the pace of improvement across the industry will ease in 2022, fundamental conditions will improve most in the refining and marketing (R&M) and oilfield services and drilling (OFS) sectors.
- **New COP-26 commitments provide momentum for accelerated decarbonization, but increased demand for oil and natural gas poses a stubborn impediment to progress.** Robust gasoline demand along with increasing international travel will underpin rising oil demand, set to surpass pre-pandemic levels despite strong continued growth in electric-vehicle sales. The corresponding increase in carbon emissions from rising oil consumption will likely lead to added investor pressure for oil companies to transition their businesses, and to inspire more policy initiatives to cut oil and gas demand.
- **Credit quality for the oil majors will further improve in 2022 after recovering strongly in 2021 from a significant deterioration in 2020.** If oil prices remain in the high end of our expected $50-$70/bbl range, the majors will be able to deliver even higher operating cash flow than they had when oil prices exceeded $100/bbl in 2014. But much of their sizeable cash flow will benefit shareholders during 2022, since the companies will remain disciplined about capital spending, and many of them no longer need to reduce their net debt.
- **National oil companies (NOCs) will struggle with their roles in guaranteeing energy security and the continuous pressure to pay more dividends and taxes to government backers that are wary of higher fiscal deficits and increasing social unease.** The energy and environmental agendas that governments and regulators push will determine oil and gas companies' business strategies and access to much-needed funding to grow and guarantee energy security. Political risk poses a particular hazard for NOCs in Latin America.
- **We expect continued consolidation in the exploration and production (E&P) sector through 2022 amid high commodity price volatility and mounting regulatory and social demands.** Producers are striving to optimize their portfolios to improve financial performance, increase the durability of their assets, extend productive capacity, and better position themselves for future energy transition and price shocks. The industry should generate substantial free cash flow in 2022 based on favorable prices and efforts to keep spending in check, providing fuel for M&A.
- **Oil and gas industry efforts to cut greenhouse gas emissions will include not only switching to renewable energy, but also a new focus on developing technologies to generate low-carbon energy sources.** Companies are exploring technologies to generate less carbon-intensive fossil fuel, and technologies that offset Scope 3 emissions—emissions from the use of fossil fuels. But the commercial viability of even the most promising low-carbon technologies appears uncertain without regulatory support or subsidies.
- **Refiners will generate higher earnings in 2022, around mid-cycle levels, and more positive free cash flow with margins expanding modestly as demand for refined products continues to improve.** Earnings from non-refining businesses such as retail sales, midstream operations and chemicals will contribute substantially to refiners' profits. But OECD consumption will remain well below 2019 levels, and crude price differentials will remain narrower than historical levels, adding some uncertainty to refiners' margins and cash flow generation.

» **Momentum for carbon pricing is rising in Asia as more countries in the region make net-zero emission pledges.** Asian oil and gas companies are already preparing for regulatory developments by announcing plans to cut emissions and diversify into cleaner businesses. Such investment implies increasing execution risks, with higher debt financing and uncertain profitability for regional companies as they bolster their oil and gas operations and make their portfolios less carbon intensive.

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Editors

Jay Sherman, Elisa Herr, Andrew Bullard, Julian Halliburton and Phil Macdonald

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