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Research Update:

Senior Secured Debt Of Elenia Finance (Elenia Verkko) Affirmed At 'BBB+' On The Group's Restructuring; Outlook Stable

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Rating Action Overview

- Finnish electricity distributor Elenia will take major steps in its restructuring on July 1, when Elenia Finance Oyj and Elenia Oy are folded into Elenia Verkko Oyj and the latter becomes the bond obligor and regulatory license owner. The restructuring will be completed on July 8.
- We view the transaction as rating neutral since, in our view, the amended finance documents continue to protect the secured debtholders and provide a strong covenant package.
- In addition, the group, which generated €183 million of EBITDA in 2019, remains on track to maintain funds from operations (FFO) to debt at 8%-9% in 2020, improving to 9%-10% in 2021 and 2022.
- We are therefore affirming our 'BBB+' issue rating on the senior secured debt issued by Elenia Finance, which will be transferred to Elenia Verkko from July 1 as the companies merge.
- The stable outlook indicates that we expect the restructuring to have no financial implications for Elenia and that FFO to debt will remain at least 8%, which is above our rating threshold, while debt to EBITDA stays below 9x in 2021-2022.

Rating Action Rationale

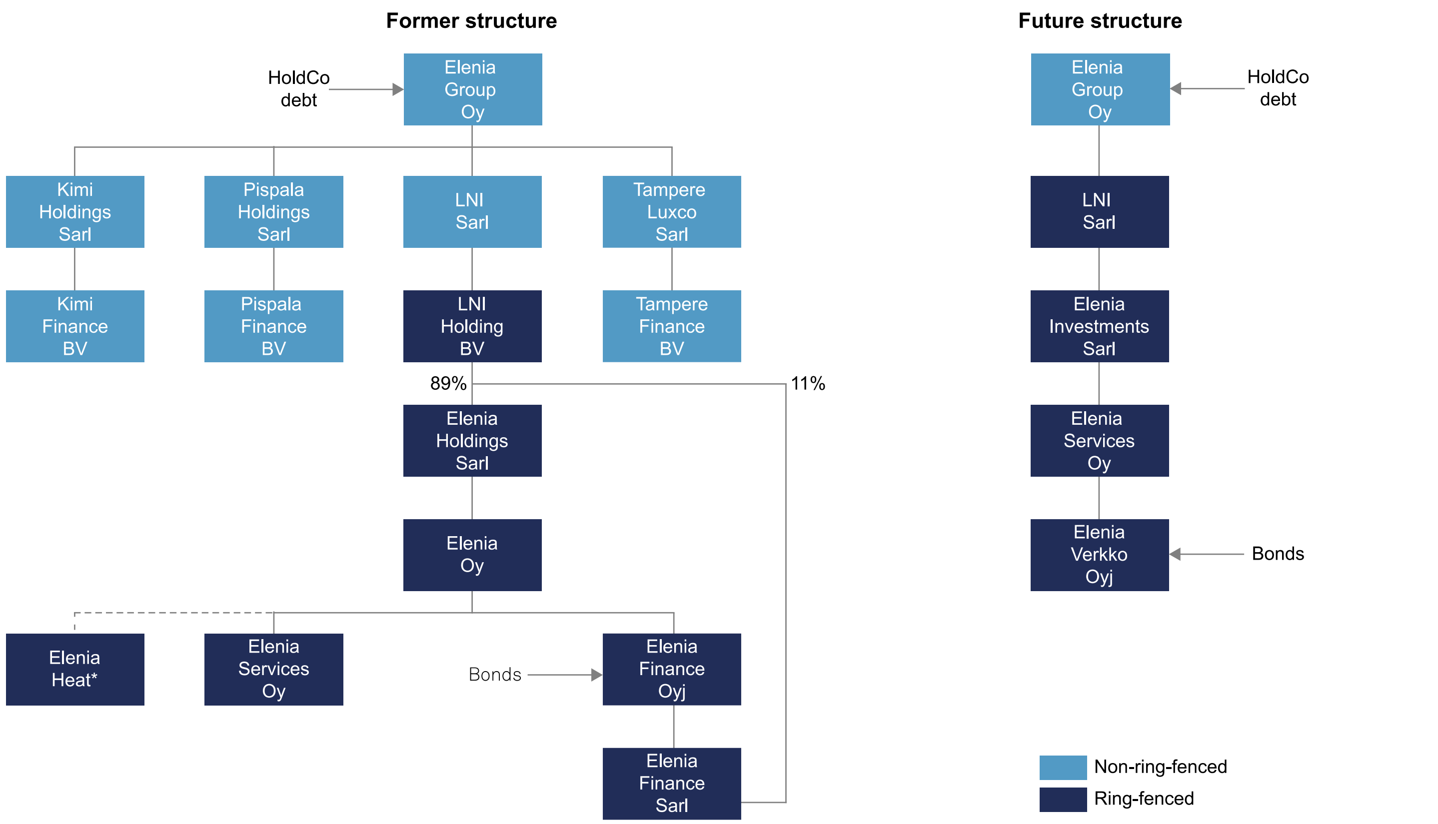
Elenia's group restructuring will take place on July 1. We assess the proposed reorganization as having limited risk for Elenia's senior secured creditors, notably due to the adequate protections delivered under the finance documents, which involve seeking the approval of creditors when appropriate through the security trustee. On Dec. 3, 2019, Elenia announced that its creditors had approved its restructuring program. The key purpose of the reorganization is to simplify the group's structure and improve the ability to service debt and return cash to the owners by:

- Removing unnecessary holding and financing companies, thereby lowering administrative costs.

- Separating regulated activities from other business activities. Elenia Verkko will conduct the regulated activities (98% of EBITDA), and Elenia Services Oy the unregulated activities (2% of EBITDA).
- Assigning the network assets, operating cash flows, and network license to the entity that services the group's debt.
- Restructuring the main equity chain.

The integration of Elenia Finance and Elenia Oy into Elenia Verkko is expected to take place on July 1. The regulator issued a new operating license to Elenia Verkko on June 25 that takes effect on July 1.

Elenia Group Oy - Organizational Chart



*Dotted line reflects sale of Elenia Heat in 2019. Source: S&P Global Ratings.

The group's restructuring is neutral to the rating. The amended finance documents still protect the holders of Elenia's secured debt and provide a strong covenant package. We understand that the restructured security package is in substance equivalent to the previous one, considering the new group structure. We understand there will be no restart of the hardening period, which refers to the time during which security is liable to be set aside if the entity granting the security enters into insolvency proceedings, or other similar claw-back periods in relation to previous security carried over into the new structure. There will inevitably be hardening periods for some new security added as part of the restructuring. However, we consider that this is appropriately mitigated by the transaction structure and does not introduce any significant new risk.

Structural features in the senior secured debt continue to support the rating. The rating remains one notch above the senior secured debt's stand-alone credit profile due to various structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Elenia to manage temporary cash flow shocks. The debtholders benefit from the following features, which include, but are not limited to:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default.
- A liquidity facility available to draw on if the group enters a standstill, and is sufficient to cover finance charges. The liquidity facility of €60 million was undrawn as of May 31, 2020.

High leverage and dividend payments still constrain the rating. Elenia's financial leverage decreased in 2019 following the sale of its heat business, the proceeds of which was used to repay all of its shareholder loans (which we treated as equity) and external debt. At year-end 2019, FFO to debt stood at 6.4%, after FFO was negatively affected by a bond repurchase during the year, and by various outflows, including tax payments for both 2018 and 2019. Although, Elenia appears committed to FFO to debt above 8% and debt to EBITDA below 9x, excluding the impact from International Financial Reporting Standards (IFRS) 15. We forecast that Elenia can keep FFO to debt at 8%-9% in 2020, and improve it to 9%-10% in 2021 and 2022, thanks to Finland's regulatory framework, which results in stable and predictable cash flows. Nevertheless, we expect debt to EBITDA to reach 9x in 2020, before declining gradually to 8.5x in 2022. The restructuring should have very limited financial impact. We do not expect any adverse tax impact on the group due to the restructuring. We expect Elenia to show flexibility in shareholder distributions to maintain credit metrics commensurate with the rating, although we note that simplification of the group's structure will improve Elenia's ability to service its debt and return cash to the owners.

Outlook

The stable outlook signifies that we expect to see steady earnings and credit metrics in the new regulatory period, despite a falling weighted average cost of capital, fueled by declining interest rates. We expect FFO to debt above 8% and debt to EBITDA below 9x throughout that period, which we consider commensurate with the 'BBB+' issue rating. We believe this will be coupled with positive IFRS equity.

Downside scenario

We could lower the rating if Elenia's FFO to debt falls below 8% or debt to EBITDA rises above 9x without clear signs of recovery. This could occur if the company increased investments or shareholder remuneration beyond our expectations.

Upside scenario

We see a positive rating action as unlikely at this stage, especially given our belief that Elenia will use its additional flexibility to either expand its investment pipeline or increase shareholder remuneration.

We could, however, consider an upgrade if Elenia were to commit to a deleveraging plan, resulting in FFO to debt sustainably above 10% and debt to EBITDA below 8x. We view this as unlikely over the outlook horizon, given the group's business plan.

Company Description

Elenia's main business operation is electricity distribution. It is the second largest electricity distribution operator in Finland behind Caruna, with a 12% market share and a network of about 72,000 kilometers serving about 430,000 end users. In 2019, the company reported EBITDA of €183 million. In February 2018, Elenia was acquired by Allianz Capital Partners on behalf of Allianz Group (45%), investment vehicles managed by Macquarie Infrastructure and Real Assets (including Macquarie Super Core Infrastructure Fund; 45%), and Valtion Eläkerahasto (The State Pension Fund of Finland; 10%). Elenia's financing structure is ring-fenced, and the financing group is delinked from its ultimate parent. The financing group's issued debt includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Our Base-Case Scenario

Assumptions

- GDP decline in Finland of about 6% in 2020 before increasing by 2.5% and 1.5% in 2021 and 2022, respectively.
- Very limited impact from COVID-19.
- Stable contribution from predictable distribution system operator activities, with the next regulatory reset date in 2024.
- Shareholder distributions of €180 million-€200 million during 2020, and €100 million-€130 million in 2021 and 2022.
- No material acquisitions.

Key metrics

Table 1

Elenia Finance Oyj Key Metrics

	--Fiscal year ended Dec. 31--				
Mil. €	**2018a**	**2019a**	**2020e**	**2021f**	**2022f**
EBITDA	195	183	190-210	220-240	225-245
EBITDA margin (%)	55	61	61-63	64-66	64-66
FFO	147	105	150-160	180-190	185-195
Interest paid	48	66	35-40	35-40	35-45
Capital expenditure	159	166	150-160	150-160	150-160

Table 1

Elenia Finance Oyj Key Metrics (cont.)

	--Fiscal year ended Dec. 31--				
Mil. €	2018a	2019a	2020e	2021f	2022f
Shareholder distributions§	217	426	180-200	100-130	100-130
Debt	1,737	1,627	1,800-1,900	1,900-2,000	1,950-2,050
Debt to EBITDA (x)	8.9	8.9	8.9-9.2	8.4-8.6	8.4-8.6
FFO to debt (%)	8.5	6.4	8.0-9.0	9.0-10.0	9.0-10.0

*All figures adjusted by S&P Global Ratings. §Shareholder distributions including: interest paid on shareholder loans,repayment of shareholder loans, dividends and upstream loans. All shareholder loans were repaid in 2019. a--Actual. e--Estimate. f--Forecast.

Liquidity

We view Elenia's liquidity as adequate. We expect liquidity to remain adequate following the restructuring. We believe that available liquidity sources should exceed forecast near-term cash outflows 2.1x. In our assessment of liquidity, we also factor in qualitative factors, such as Elenia's sound relationships with banks, satisfactory standing in credit markets, and likely ability to absorb high-impact, low-probability events with limited refinancing. We assume that Elenia will maintain adequate headroom under its financial covenants.

Principal liquidity sources:

- As of March. 31, 2020, these comprise FFO that we forecast at about €170 million.
- Available cash and marketable securities of about €333 million.
- Access to committed credit lines of about €570 million.

Principal liquidity uses:

- Expected liquidity uses as March 31, 2020, include capex of about €155 million over the next 12 months.
- Shareholder distributions of €180 million-€200 million in 2020.
- Debt repayment of €90 million during 2020.

Covenants

Elenia has two covenants stipulating an interest coverage ratio and a leverage ratio (debt to EBITDA), with two different trigger ratios: a lock-up trigger (for shareholder distributions) and a default trigger.

Table 2

Elenia Covenant Triggers

	--Debt to EBITDA--		--Interest coverage ratio--	
	Lock-up	Default	Lock-up	Default
Covenant (x)	10.18	11.33	1.46	0.96
2019 ratio (x)	8.65		3.55	
2018 ratio (x)	8.87		4.05	

Source: Elenia Finance Ojy.

According to Elenia's calculations, as of Dec. 30, 2019, the ratios were 8.65x and 3.55x, respectively, showing headroom at both covenant levels, and we believe that headroom will decrease over the next 12 months before increasing again. At the same time, we believe Elenia has significant flexibility to reduce shareholder distributions before reaching the lock-up trigger level.

There are two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default. These covenants provide creditors with significant control over Elenia at an early stage of financial or operational difficulty, or following material changes in business circumstances. The covenants reduce the borrower's probability of default and create an additional credit cushion.

A liquidity facility provided by suitably rated counterparties is available to draw on if the group enters a standstill, and is sufficient to cover finance charges. The liquidity facility of €60 million was undrawn as of May 31, 2020.

There is a strong covenant package to protect debtholders, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.

Ratings Score Snapshot

Senior Secured Debt: BBB+/Stable

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)

- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Structural enhancements: (+1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

- Research Update: Elenia Finance Oyj's Senior Secured Debt Upgraded To 'BBB+' From 'BBB' On Asset Sale And Supportive Financial Policy, Nov. 25, 2019

Ratings List

Ratings Affirmed

Elenia Finance Oyj	
Senior Secured	BBB+/Stable