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Ratings

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Summary:
Elenia Finance Oyj

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Rationale

The 'BBB' ratings on the secured debt of Finnish electricity distribution and district heating company Elenia Finance Oyj are based on S&P Global Ratings' assessment of Elenia's stand-alone credit profile at 'bbb-' and a one-notch uplift for structural enhancements.

Business Risk	Financial Risk
• About 85% of operations in regulated electricity distribution, with stable and predictable revenues and cash flows. • About 15% of operations in district heating, with a natural monopoly position in the catchment area, although there are some volume and commodity risks.	• An aggressive financial policy, under which all free cash is distributed to shareholders. • High debt, and expectations of gradually weakening credit metrics resulting from a fully debt-funded capital expenditure (capex) program and high shareholder distributions. • Flexibility to adjust shareholder distributions and capex to unexpected deterioration of cash flows. • Credit-supportive structural features.

Outlook

The stable outlook on Elenia Finance reflects our expectations of the group's continued stable earnings and cash flows from low-risk, regulated electricity distribution business. We believe that Elenia should be able to maintain a financial risk profile in line with our expectations for the ratings on the debt, including adjusted funds from operations (FFO) to debt of at least 6%.

Downside scenario

Assuming no change to the business risk profile, we could lower the ratings should Elenia struggle to maintain adjusted FFO to debt of at least 6%, taking into account some variation with regard to the annual regulatory surplus or deficit.

Upside scenario

Given our assessment of high leverage and relatively weak credit metrics, combined with an aggressive financial policy, we see the likelihood of an upgrade as limited at this time. However, we could consider raising the ratings if Elenia's financial policy were to change, leading to stronger credit measures than we currently expect, for example with adjusted FFO to debt exceeding 8% on a sustainable basis.

Our Base-Case Scenario

In our base case, we expect that Elenia will report higher earnings from its regulated electricity distribution business, following the increase in the regulatory allowed return from 2016. However, we expect that substantially all of the free operating cash flows will be distributed to shareholders. Consequently, we forecast that Elenia's adjusted ratio of FFO to debt will gradually weaken to about 7%-7.5% over the next few years from 8.4% in 2015.

Assumptions

- A gradual increase in the EBITDA margin of the distribution business to about 58%-60%, reflecting the improved weighted average cost of capital from 2016 and modest growth of the asset base.
- For the district heating operations, we assume that the EBITDA margin will be about 25%-27%, leading to a group margin of about 55%.
- Annual capex of about €120 million over 2016-2017.
- Increased leverage as a result of relatively generous shareholder distributions.

Key Metrics

	2015a	2016e	2017f
EBITDA Margin (%)	47.7	50-52	53-55
FFO/debt (%)	8.4	8-9	7.5-8.5
Debt/EBITDA x	8.9	8.5-9.5	8.5-9.5

a--actual. f--Forecast. e--Estimate.

Business Risk

We regard Elenia group's business risk profile as excellent, mainly due to our assessment of the fully regulated electricity distribution business, which accounts for approximately 85% of the group's EBITDA. We consider the Finnish regulatory framework for electricity distribution network companies to be well established, predictable, and supportive. We believe that the modifications to the framework for the regulatory period starting 2016 support Elenia's credit profile, since they have increased the allowed regulatory return for the operators. The main modification is a change in the calculation of the risk-free rate in the regulatory weighted average cost of capital (WACC), which has contributed to an increase in the WACC to about 5.9% (after tax) from 3.1%. The change is intended to support investments in the grids to renew the aged network and reduce outages, for example caused by storms.

The regulatory framework has, however, some relative weaknesses regarding recovery of costs in the event of extraordinary weather conditions, although such events are rare and therefore the related risk is sufficiently contained. We also note that, although the district heating business does not benefit from a similar regulatory framework, it operates as a natural monopoly and shows stable profitability. We therefore anticipate that the Elenia group will continue to generate stable and predictable cash flows.

Financial Risk

Elenia's aggressive financial risk profile is constrained by high debt, and we expect its credit measures will weaken. We anticipate that FFO to debt will deteriorate toward 7% over the next few years and that debt to EBITDA will be close to the 9.5x covenant threshold over most of the remaining term of the debt. We assume that the company will increase debt under the capex facility to fund future investments, while distributing all available cash flow to shareholders in the form of interest on, or repayment of subordinated loans ultimately from shareholders. Our forecast is further supported by the limited incentive under the debt program's structure for Elenia to target credit measures that are materially stronger than the covenant levels.

In our assessment of Elenia's stand-alone credit profile, we also take into consideration that all of the shareholders' participation is in the form of subordinated loans, which--although we treat them as equity--indicate a more aggressive structure than one in which the shareholder participation is in the form of pure equity.

Liquidity

We view Elenia's liquidity as adequate. We believe that available liquidity sources (cash, committed credit facilities, and operating cash flow) should be in excess of 1.1x of forecast near-term cash outflows, such as shareholder loan distributions and committed capex. 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 continue to maintain adequate headroom under its financial covenants.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments of about €30 million as of June 30, 2016. • FFO of €120 million or more over the next 12 months. • €245 million available under credit facilities as of June 30, 2016.	• Capex of about €120 million over the next 12 months. • Shareholder distributions, which we understand are undecided and flexible, but which we assume would likely be in excess of €60 million annually on average.

Covenants

Elenia's financing structure includes the following financial covenants for events of default:

- Net debt/EBITDA of 10.5x.
- FFO/Net finance charges of 1.2x.

The documentation also includes lock-up covenants for shareholder distributions, which are:

- Net debt/EBITDA of 9.5x.
- FFO/Net finance charges of 1.7x.

As of June 30, 2016, the ratios were 7.65x and 4.46x respectively, showing significant headroom at both covenant levels, although we believe headroom will gradually reduce as a result of increasing shareholder distributions.

Other Credit Considerations

The ratings on the notes also reflect various structural features in the notes that, in our view, increase cash flow certainty for debtholders. These include payment restrictions and the covenanted liquidity structure that we believe should allow Elenia to manage temporary cash flow shocks and keep secured creditors in a strong position should the group fall into financial difficulty.

Related Criteria And Research

Related Criteria

- Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses - February 24, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Project Finance Transaction Structure Methodology - September 16, 2014
- Project Finance Framework Methodology - September 16, 2014
- The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities - April 29, 2014
- Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Methodology: Industry Risk - November 19, 2013
- Corporate Methodology - November 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Country Risk Assessment Methodology And Assumptions - November 19,
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- Counterparty Risk Framework Methodology And Assumptions - June 25, 2013

Related Research

- Why Finnish Electricity Networks Have A Strong Regulatory Advantage, Dec. 2, 2014

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