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Summary:
Elenia Finance Oyj

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Summary:
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Rationale

Long-term secured debt rating: BBB

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 its area of operations, although it has some volume and commodity risk. • Some relative weaknesses regarding regulatory incentives in the event of extraordinary weather conditions, although we view such events as rare.	• Aggressive financial policy, under which all free cash is distributed to shareholders. • High debt, and expectations of gradually weakening credit metrics resulting from the fully debt-funded capital expenditure (capex) program and high shareholder distributions. • Flexibility to adjust shareholder distributions to unexpected deterioration in cash flows. • Credit-supportive structural features.

Underlying Outlook

Our view of the underlying credit quality of Finnish electricity distribution and district heating group Elenia group and related entity Elenia Finance Oyj reflects our expectations of continued stable earnings and cash flows reflecting the group's 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, including adjusted funds from operations (FFO) to debt of at least 6%.

Downside scenario

Rating downside could result from any unfavorable changes to the Finnish regulatory framework for electricity distribution operators (DSOs). This could lead us to review Elenia's excellent business risk profile, and as a consequence, we could lower our assessment of its underlying credit quality. In addition, we could lower the ratings, should Elenia struggle to maintain adjusted FFO to debt of at least 6%, taking into account some variation with regards to annual regulatory surplus/deficit. A negative rating action could also follow should Elenia group enter into significant super-senior hedges, because this could weaken the position of senior creditors in a financial stress scenario.

Upside scenario

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

Standard & Poor's Base-Case Scenario

The main rating constraint is the high level of debt, which results in relatively weak cash flow debt-coverage metrics. In our base case, we expect that Elenia will continue to generate stable earnings from its regulated electricity distribution business. However, we anticipate that Elenia's adjusted ratio of FFO to debt will gradually weaken to about 7% over the next few years, from about 11% in 2014, because of the expected 100% debt funding of future capex and likely generous shareholder distributions.

Assumptions

- A relatively stable EBITDA margin in the distribution business at about 51%-54%, reflecting the preset weighted average cost of capital formula and modest growth of the asset base.
- For the district heating operations, we assume that the EBITDA margin will be about 25%-27%.
- Annual capex of about €100 million over 2015-2016.
- Increased leverage as a result of fully debt-funded investments and relatively aggressive shareholder distributions.

Key Metrics

	2014	2015e	2016e
FFO/debt (%)	10.7	7.5.0-9.0	7.0-8.0
Debt/EBITDA (x)	7.1	7.5-9.0	8.5-9.5

Figures fully adjusted by Standard & Poor's. e--Estimate. Shareholder loans of €651 million treated as equity in ratio calculation.

Business Risk

We base our view of the Elenia group's excellent business risk profile mainly on 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 companies to be well established, predictable, and supportive. Although there are relative weaknesses regarding regulatory incentives in the event of extraordinary weather conditions, we view such events as rare and therefore the related risk as sufficiently contained. We also note that the district heating business does not benefit from a similar regulatory framework, but 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 financial risk profile is pressured by high debt and our expectation of weakening credit measures. We anticipate that FFO to debt will deteriorate toward 7% in the next few years and that debt to EBITDA will be close to the 9.5x covenant threshold over most of the life of the transaction. We assume that the company will increase debt under the capex facility to fund future investments, while at the same time distributing all available cash flow to shareholders in the form of interest or repayment on shareholder loans. Our forecast is further supported by the limited incentive under the program structure for Elenia to target debt-protection measures that are materially higher than the covenant levels.

We also take into consideration the fact that all of the shareholder participation in the structure is in the form of shareholder loans, which, while assessed as equity, is more aggressive on a comparable basis than a structure where shareholder participation is in the form of pure equity.

Liquidity

We view Elenia's liquidity as adequate. We believe that available liquidity sources in terms of 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 a sound relationship with banks, satisfactory standing in credit markets, and likely ability to absorb high-impact, low probability events with limited re-financing. We assume that Elenia will continue to maintain adequate headroom under its financial covenants. We also note that the large capex facility, which accounts for €211 million of the €316 million available in facilities, can only be used for capex and acquisitions, and not for covering shareholder distributions.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments of about €18 million as of Dec. 31, 2014. • FFO of about €85 million-€100 million annually over 2015-2016. • €316 million available under credit facilities as of Dec. 31, 2014, of which €211 million under the capex facility.	• Capex of about €100 million per year in 2015 and 2016. • Shareholder distributions, which we understand are undecided and flexible, but which we assume would likely be in excess of €60 million annually on average.

Structural Enhancements

The ratings also reflect various structural features in the notes that, in our view, increase cash flow certainty for debtholders. These include payment restrictions and a covenanted liquidity structure that we believe would allow Elenia to manage temporary cash flow shocks and keep secured creditors in a strong position should the group fall into financial difficulty. On the other hand, in our view, the notes' structure and the Finnish regulatory environment are less robust than in other markets.

Related Criteria And Research

Related Criteria

- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012

Related Research

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

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