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Research Update:

Outlook On Elenia Finance's Senior Secured Debt Revised To Positive On District Heating Disposal

July 10, 2019

Rating Action Overview

- On July 1, 2019, Elenia Finance Oyj (Elenia) agreed to fully divest its district heating business, Elenia Lämpö Oy (Elenia Heat), to a consortium of financial investors. While the sales price has not been disclosed, it is our understanding that the divestment will result in tax-free capital gain in excess of €250 million. The transaction should be finalized over the next few weeks.
- We expect this transaction, if finalized, to have a marginally positive impact on our assessment of Elenia's business risk, since 100% of its earnings will be derived from fully regulated power distribution activities in Finland following the disposal.
- We understand that the company intends to use at least €225 million of the proceeds to repay external debt. We would therefore expect the ratio of adjusted funds from operations (FFO) to debt to exceed 8% in 2019-2020, which we view as commensurate with a higher rating.
- As a result, we are revising our outlook to positive from stable on Elenia's senior secured debt and affirming the 'BBB' rating.
- The positive outlook reflects the potential of an upgrade within the next two years if the divestment of Elenia Heat goes according to plan and we are convinced that the company is able to maintain adjusted FFO to debt above 8% with adjusted debt to EBITDA below 9x.

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Rating Action Rationale

The now positive outlook captures the expected debt repayment following the announced divestment of Elenia Heat to SL Capital Infrastructure II SCSP, DIF Infrastructure V Coöperatief U.A., and LPPI Infrastructure Investments LP. It also reflects our expectation of the transaction's marginal positive impact on our assessment of Elenia's business risk. This is because, following the disposal, 100% of its earnings will be derived from fully regulated power distribution activities in Finland.

On July 1, 2019, Elenia agreed to fully divest its Elenia Heat to a consortium of financial investors for an undisclosed amount. It is our understanding that it results in a tax-free capital gain of about €250 million. Elenia Heat is the owner and operator of 16 local district heating networks in Finland, serving about 85,000 customers. The transaction should be finalized over the next few weeks. We understand that the company intends to use a minimum of €225 million to repay external interest-bearing debt during the autumn. We expect the remaining part of the proceeds to be used for repayment of shareholder loans and distribution to the shareholders.

Although we note the possible benefits of the transaction on Elenia's business risk profile, we note that the transaction will likely weigh on Elenia's scale and diversity. This is because Elenia Heat's contribution to overall EBITDA was about 15% of total EBITDA, reported at €25 million in 2018. Still, it is our understanding that the EBITDA margin in the district heating business is lower than the margin achieved by power distribution activities in Finland.

Furthermore, given repayment of external debt, we expect the transaction to be marginally positive for Elenia's debt profile, with our adjusted credit metrics remaining broadly stable in the next two years. In particular, we anticipate that the company's FFO-to-debt ratio will stay above 8% over the next two years and debt to EBITDA below 9x.

Outlook

The positive outlook indicates that we could raise the ratings on the senior secured debt over the next 12-24 months if Elenia successfully divests its district heating business and repays at least €225 million of its external interest bearing debt.

This could translate to adjusted FFO to debt sustainably above 8% and adjusted debt to EBITDA below 9x, our thresholds for an upgrade, while creating a comfortable equity position. This would lead us to revise up our assessment of Elenia's stand-alone credit profile from 'bbb-' to 'bbb' and apply a one-notch uplift to the rating.

Downside scenario

We could revise the outlook to stable if Elenia does not complete the transaction and repay at least €225 million of interest bearing debt and fails to repay the shareholder loan. We could also revise the outlook to stable if Elenia does not follow through with the divestment or should the divestment result in additional shareholder remuneration than we currently project.

Company Description

Elenia's main business operation is electricity distribution, and it is the second-largest electricity distribution operator in Finland, with a 12% market share and a network of roughly 70,200km. Elenia was recently acquired by Allianz Capital Partners, on behalf of the Allianz Group (45%), Macquarie Infrastructure and Real Assets (45%), and Valtion Eläkerahasto (The State Pension Fund of Finland; 10%). Elenia's financing structure is ring-fenced, and the financing group is de-linked from its ultimate parent company. The debt issued by the financing group includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Our Base-Case Scenario

In our base case (excluding Elenia Heat from end-July 2019), we assume:

- Stable contribution from its predictable DSO activities, supporting EBITDA generation with EBITDA margins at 58%-60% in 2019 and at 65%-68% in 2020.
- Capital expenditure (capex) of around €150 million annually over the coming two years.

- A minimum debt repayment of €225 million in 2019.
- Remainder of the sale proceeds to be used for repayment of shareholder loans and other distributions to shareholders.
- Comfortable equity position.
- No material acquisitions.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures:

- FFO to debt of about 8%-10% in 2019 and 2020, excluding the district heating business.
- Debt to EBITDA of 8x-9x in 2019 and 2020.

Liquidity

We view Elenia's liquidity as adequate. We expect liquidity to remain adequate in event the divestment is finalized. We believe that available liquidity sources (cash, committed credit facilities, and operating cash flow) should be in excess of 1.1x forecast near-term cash outflows, such as dividends 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.

Covenants

Elenia modified its covenants to mitigate the impact of the International Financial Reporting Standards (IFRS) accounting treatment of connection charge revenues. The impact is approximately six percent based on 2017 consolidated IFRS EBITDA. Over a period of 30 years, these will return to the original covenant levels in 10-year increments.

The leverage trigger is set to 10.18x and the default trigger is set to 11.33x, together with the issuer credit rating-trigger at 1.46 and the issuer credit rating-default at 0.96x.

Elenia continues to comply with its debt restriction covenants stipulated in its documentation and as per our analysis below. According to our calculations, as of March 31, 2019, the ratios were 9.79x and 4.17x, respectively, showing headroom at both covenant levels, and we believe that headroom will increase over the next 12 months. At the same time, we believe that Elenia has great flexibility to reduce shareholder distributions even before reaching lock-up covenants.

Structural Enhancements

The ratings on the notes capture various structural features designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenant liquidity structure that should, in our opinion, enable Elenia to manage temporary cash flow shocks. The debtholders benefit from several features, including:

- 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 earlier 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 remains undrawn at the end of June 2019 and amounts to €60 million.
- 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 Rating: BBB/Positive

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: Negative (-1 notch)

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 Transaction Structure Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Structured Finance | General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, 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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Elenia Finance Oyj		
Senior Secured	BBB/Positive	BBB/Stable