S&P Global Ratings

RatingsDirect®

Elenia Verkko Oyj

Primary Credit Analyst:
Emeline Vinot, Paris + 33 014 075 2569; emeline.vinot@spglobal.com

Secondary Contact:
Per Karlsson, Stockholm + 46 84 40 5927; per.karlsson@spglobal.com

Table Of Contents

Credit Highlights

Outlook

Our Base-Case Scenario

Company Description

Peer Comparison

Business Risk

Financial Risk

Liquidity

Covenant Analysis

Environmental, Social, And Governance

Ratings Score Snapshot

Related Criteria

Elenia Verkko Oyj

Credit Highlights

None

Overview

Key strengths	Key risks
A regulatory framework with supportive cost coverage that underpins stable cash flows via tariffs.	Uncertainty over the new regulatory framework starting 2024, which is expected to be finalized in second-half 2023.
Strong, monopoly-like position as Finland's second-largest electricity distribution system operator (DSO).	History of political intervention weakens our view of the assessment.
Our expectation that the owners will remain supportive and committed to maintaining funds from operations (FFO) to debt of above 8%, which is commensurate with the rating.	Annual investments of about €150 million over 2024-2036 to support the energy transition and ensure security of supply. Combined with high albeit flexible shareholder distributions of up to €150 million over 2023-2024, we forecast negative discretionary cash flow (DCF) over the next regulatory period.
A protective financing structure, since debt includes structural enhancements that reduce the likelihood of default and the risk to creditors.	High leverage, with S&P Global Ratings-adjusted FFO to debt of about 9% and debt to EBITDA below 9x on average over 2023-2026.

Elenia Verkko Oyj (Elenia) operates under a supportive regulatory framework, which, together with its operational efficiency, should continue to translate into healthy cash flows. S&P Global Ratings views the regulatory framework that Elena operates under as strong/adequate, since it allows for full cost coverage and protects DSOs from inflation and volume risks:

- The operating expenditure (opex) allowance is adjusted annually with inflation
- Regulatory asset value (RAV) is based on the unit price survey, which reflects inflation at the start of each regulatory period
- DSOs can also increase tariffs (to a limit of 8% per rolling 12 months under the updated energy act) to compensate for lower volumes distributed

We therefore expect Elenia's EBITDA margins to remain at 60%-65% over 2023-2026, including the upcoming regulatory period.

Under the regulatory framework, Elenia benefits from incentives on measures of quality, efficiency, investment, and innovation. An additional incentive related to flexibility is proposed to be introduced in 2024. Furthermore, Elenia benefits from its position as the second-largest DSO in Finland, with the sizable network allowing for economies of scale thanks to better operational efficiency.

Although we view the Finnish electricity framework as mostly supportive, due to political intervention within the 2019-2023 regulatory period we revised down our view of it to strong/adequate from strong during 2022. This followed the regulator's introduction of a weighted-average 17% cut in existing RAV from 2022, in addition to an almost 100-basis-point (bps) cut in the weighted-average cost of capital (WACC) formula for Finnish DSOs from 2022. In our view, changes during a regulatory period increase uncertainty around future variations to DSOs' compensation.

Many DSOs have appealed the changes, but we understand that a court verdict is unlikely before 2024, and financial advantages if the court rules in favor of the DSOs are limited (see "Finnish Power Distributor Elenia Downgraded To 'BBB' On Regulatory Changes; Off CreditWatch Negative; Outlook Stable," published Jan. 28, 2022, on RatingsDirect).

We have limited visibility on any changes to the regulatory framework for the period starting 2024. The Energy Authority (EA) has still not presented the final framework. Based on preliminary EA data, we expect, but don't fully exclude, that changes will be limited. This is because we understand that the key changes to the framework were already implemented in 2022. That said, upcoming changes could include as an example:

- A flexibility incentive to be implemented in 2024.
- A profit-sharing mechanism on capital expenditure (capex).

Uncertainties remain regarding the calibration of the unit prices, which will be key for the upcoming period and should be published in the autumn. We'll review our assessment of the regulatory framework once all information is publicly available.

We believe that Elenia remains committed to keeping FFO to debt above 8% and significant headroom under its covenants. Elenia's owners have been flexible about its financial policy, sizing shareholder remuneration to protect the credit ratios and comply with covenants, which we believe will remain the case. For example, Elenia distributed €70 million and €33.6 million to shareholders in 2021 and 2022 respectively. We therefore expect shareholder remuneration to vary year on year depending on the headroom under the 8% FFO-to-debt threshold.

The senior secured debt has supportive features that lift the rating one notch above the stand-alone credit profile (SACP). Structural features of the debt are designed to increase cash flow certainty for debtholders. Among them, restricted payment conditions and a covenanted liquidity structure that should enable Elenia to manage temporary cash flow shocks. These include:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default; and
- A €70 million liquidity facility available to draw on if the company enters a standstill, which is sufficient to cover finance charges at least for one year.

Outlook

The stable outlook reflects our expectation that Elenia's FFO will remain at €170 million-€180 million over 2023-2026, despite the regulatory changes that came into effect in 2022. We continue to expect that Elenia's shareholder will use its flexibility to adjust distributions to protect its credit metrics if necessary. Therefore, we expect FFO to debt to remain comfortably at about 9%, and debt to EBITDA on average below 9x, which we consider commensurate with a 'bbb-' SACP.

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 increases investments or shareholder remuneration beyond our expectations.
- The regulator imposes additional changes to the framework for the 2024-2027 regulatory period that would have a significant negative impact.

Upside scenario

We see a positive rating action as unlikely at this stage, especially given our belief that Elenia will either expand its investment pipeline or increase shareholder remuneration. However, we could consider an upgrade if Elenia commits to a deleveraging plan that results in FFO to debt rising sustainably above 10% and debt to EBITDA falling below 8x.

Our Base-Case Scenario

Assumptions

- Finland's GDP growth is expected to be flat in 2023 and increase 1.1% in 2024 and 1.4% in 2025.
- Pretax WACC at 6.1% for 2023 and within 6.5%-7.0% afterward, increasing in line with a higher cost of debt.
- EBITDA margins of about 60%-65%.
- The company activates its cumulative allowed income due to a deficit, to smoothen the effect from the cut in RAV and lower WACC. That deficit is expected to be €55 million at year-end 2023.
- Flexible shareholder distributions of €100 million-€150 million over 2023-2024
- Capex of €110 million-€120 million in 2023 and €140 million-€150 million from 2024.
- Cash interest paid increases following the 2022, €150 million drawdown at higher interest rates.
- No mergers or acquisitions.

Key metrics

Elenia Verkko Oyj consolidated--Key metrics				
(Mil. €)	**2021a**	**2022a**	**2023f**	**2024f**
EBITDA	223.3	213.8	210-220	220-230
Funds from operations (FFO)	178.4	169.4	170-180	170-180
Capital expenditure	157.2	153.7	100-120	140-160
Shareholder remuneration	70.0	34.0	140-160	90-110
Debt	1,767.0	1,785.5	1,800-1,900	1,900-2,000
Debt to EBITDA	7.9	8.4	8.5-9.0	8.5-9.0
FFO to debt (%)	10.1	9.5	9.0-9.5	8.5-9.0

*All figures adjusted by S&P Global Ratings. a--Actual. f--Forecast.

We forecast that debt will continue to moderately increase over the forecast period, alongside EBITDA and FFO, meaning leverage ratios should be broadly unchanged. We expect sizable capex of about €150 million a year from €100 million-€120 million in 2023, and dividends of €100 million-€150 million over 2023 and 2024 and €40 million-€50 million afterward, which the group cannot cover with internally generated cash flow. In turn, we forecast that debt will reach about €2 billion by year-end 2026 from €1.8 billion in 2022. Since we forecast a similar trend for EBITDA over the same period, we expect average debt to EBITDA to remain in line with historical levels of about 8x-9x and FFO to debt comfortably at 8%-10%, which we consider commensurate with a 'bbb-' SACP. Since Elenia benefits from protective structural features, enhancing the SACP by one notch, we put emphasis on the two covenants (interest coverage and leverage) under which Elenia has plenty of headroom. As a result, we do not expect the debt increase to imply any covenant breach. This is because the company is allowed to exclude exceptionally high costs for grid losses from its covenant calculations, meaning they are treated as an extraordinary item. It is our understanding that Fingrid's waived tariffs are also not included in the covenant calculations.

Company Description

Elenia's main business operation is electricity distribution. It is the second-largest electricity DSO in Finland, behind Caruna Networks Oy, with a 12% market share and a network of about 76,700 kilometers, serving about 438,000 end users. In 2022, the company reported EBITDA of €204 million, excluding International Financial Reporting Standard (IFRS) 15 adjustments.

Elenia's main owners are Valtion Eläkerahasto and Allianz Capital Partners (ACP) on behalf of the Allianz Group, together with Allianz subsidiaries and investment vehicles managed or advised by ACP and Macquarie Super Core Infrastructure Fund.

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 the risk to creditors.

Peer Comparison

Table 1

Elenia Verkko Oyj--Peer comparison

Industry sector: Electric

	Elenia Verkko Oyj	Caruna Networks Oy	Ellevio AB
Ratings as of June 8, 2023	-/-/-	BBB/Stable/--	-/-/-
	--Fiscal year ended Dec. 31, 2022--		
(Mil. €)			
Revenue	331.2	484.6	687.5
EBITDA	213.8	313.8	363.6
Funds from operations (FFO)	169.4	253.8	256.9
Interest expense	37.1	52.5	110.0
Cash interest paid	39.1	56.5	105.3
Cash flow from operations	164.5	173.0	337.7
Capital expenditure	153.7	126.2	291.6
Free operating cash flow (FOCF)	10.8	46.9	46.0
Discretionary cash flow (DCF)	(22.8)	(54.9)	46.0
Cash and short-term investments	51.2	58.3	1.3
Debt	1,785.5	2,538.3	3,536.8
Equity	(148.5)	732.6	3,114.4
Adjusted ratios			
EBITDA margin (%)	64.6	64.8	52.9
Return on capital (%)	7.7	5.8	3.0
EBITDA interest coverage (x)	5.8	6.0	3.3
FFO cash interest coverage (x)	5.3	5.5	3.4
Debt/EBITDA (x)	8.4	8.1	9.7
FFO/debt (%)	9.5	10.0	7.3
Cash flow from operations/debt (%)	9.2	6.8	9.5
FOCF/debt (%)	0.6	1.8	1.3
DCF/debt (%)	(1.3)	(2.2)	1.3

Elenia, similar to its Nordic peers Caruna (BBB/Stable) and Ellevio (issue rating: BBB/Stable), operates in a stable regulatory environment with historical transparency and predictability. It is the second largest DSO in Finland, with more than a 12% market share in terms of network length, after Caruna. Ellevio AB is a Swedish DSO operating under a regulatory framework that we view as strong. All three companies face similar weather conditions so have large capex programs to reduce outages through underground cabling and increased security of supply.

Although the type of operations, market positions, and profitability are very similar for the three DSOs, and hence the business risk profiles, there are some important differences in the capital structure. Following the 2019 repayment of Elenia's shareholder loans, only Caruna and Ellevio have shareholder loans and we do not expect them to repay these in the medium term. Caruna's shareholder loans amount to about €780 million and Ellevio's about €2 billion. We exclude the loans from debt in our ratio calculations, reflecting their equity-like features such as subordination, maturity dates beyond those on other debt, and the possibility of accruing interest. In addition, Elenia and Ellevio both benefit from supportive structural features that lift the rating one notch. For Elenia, these structural features include restricted payment conditions and a covenanted liquidity structure that should enable it to manage temporary cash flow shocks. Comparatively, we view Caruna as slightly stronger in terms of financials, therefore benefitting from a higher SACP.

Business Risk

Elenia benefits from low-risk, stable network operations within a framework we view as mostly credit supportive; or strong/adequate. The company's position as the second biggest DSO in Finland with a widespread network underpins its business risk profile. We revised our assessment of the Finnish regulatory framework for electricity DSOs to strong/adequate from strong in January 2022. The Finnish EA is a regulatory body independent from the government.

Finnish regulatory remuneration is based on a determined regulatory asset base (RAB) and WACC, with the regulator allowing the full recovery of opex and capex, including inflation. DSOs still benefit from incentives on measures including quality, efficiency, innovation, and investment. Upon the start of the new regulatory period in January 2024, we do not expect any changes that could further revise our assessment of the Finnish regulatory framework for electricity DSOs, although we have limited visibility.

That said, Elenia is one of the largest network operators in Finland. We expect that Elenia will remain one of the most efficient operators, partly thanks to its economies of scale, resulting in stable and predictable cash flows. We therefore regard Elenia's business risk profile as excellent. We expect profitability, as measured by the EBITDA margin, to remain at 60%-65% over 2023-2026.

Financial Risk

Elenia's earnings are fully derived from regulated DSO activities that we see as stable and predictable. We therefore expect the company's S&P Global Ratings-adjusted FFO over 2023-2026 to remain at about €170 million-€180 million, driven by an increasing RAB and a WACC that allows for a higher allowed regulatory return. Due to the highly inflationary environment in Europe, we expect the WACC for Finnish DSOs to increase to about 6.1% in 2023 and within 6.5%-7.0% thereafter, expanding in line with the increasing cost of debt. This compares with 4.0% in 2022 and 5.4% in 2021.

Elenia's capex program for the next 10 years was submitted to the EA in 2022. Elenia lowered its capex in 2023 to about €110 million-€120 million, from €150 million-€160 million historically, but it is expected to increase to about €140 million-€150 million from 2024 because more investment is needed related to the energy transition. Combined with shareholder distributions that vary so long as FFO to debt remains above 8%, we expect Elenia's DCF to be negative over our forecast period and stabilize at about negative €40 million-€30 million from 2025, slowly increasing overall debt.

We forecast that Elenia's adjusted financial debt will reach €2 billion by 2026, up from €1.8 billion in 2022. However, we expect its financial policy to be unchanged, resulting in flexible shareholder distributions to maintain FFO to debt above 8%, which is consistent with the rating.

Financial summary

Table 2

Elenia Verkko Oyj--Financial summary					
Industry sector: Electric					
	--Fiscal year ended Dec. 31--				
	2022	**2021**	**2020**	**2019**	**2018**
(Mil. €)					
Revenue	331.2	340.8	309.9	298.6	353.7
EBITDA	213.8	223.3	195.1	182.7	194.6
Funds from operations (FFO)	169.4	178.4	147.8	104.6	146.9
Interest expense	37.1	37.0	40.9	64.8	47.5
Cash interest paid	39.1	39.6	42.0	66.4	47.6
Cash flow from operations	164.5	188.6	164.7	118.9	119.6
Capital expenditure	153.7	157.2	164.4	166.1	158.7
Free operating cash flow (FOCF)	10.8	31.4	0.3	(47.2)	(39.1)
Discretionary cash flow (DCF)	(22.8)	(38.6)	(112.7)	(221.4)	(73.8)
Cash and short-term investments		71.8	113.8	29.2	17.4
Gross available cash	51.2	71.8	113.8	29.2	17.4
Debt	1,785.5	1,767.0	1,731.0	1,627.3	1,737.6
Equity	(148.5)	(204.2)	(259.8)	219.7	115.2
Adjusted ratios					
EBITDA margin (%)	64.6	65.5	63.0	61.2	55.0
Return on capital (%)	7.7	8.9	6.9	5.4	5.8
EBITDA interest coverage (x)	5.8	6.0	4.8	2.8	4.1
FFO cash interest coverage (x)	5.3	5.5	4.5	2.6	4.1
Debt/EBITDA (x)	8.4	7.9	8.9	8.9	8.9
FFO/debt (%)	9.5	10.1	8.5	6.4	8.5
Cash flow from operations/debt (%)	9.2	10.7	9.5	7.3	6.9
FOCF/debt (%)	0.6	1.8	0.0	(2.9)	(2.2)
DCF/debt (%)	(1.3)	(2.2)	(6.5)	(13.6)	(4.2)

Reconciliation

Table 3

Elenia Verkko Oyj--Reconciliation of reported amounts with S&P Global Ratings' adjusted amounts (mil. €)								
	--Fiscal year ended Dec. 31, 2022--							
Elenia Verkko Oyj reported amounts								
	Debt	**Revenue**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Dividends**
Reported	1,833.0	321.6	204.2	113.9	37.0	213.8	164.6	--
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(5.4)	--	--
Cash interest paid	--	--	--	--	--	(39.0)	--	--
Reported lease liabilities	2.1	--	--	--	--	--	--	--
Incremental lease liabilities	1.3	--	--	0.0	0.0	(0.0)	(0.0)	--
Postretirement benefit obligations/deferred compensation	0.2	--	--	--	0.0	--	--	--
Accessible cash and liquid investments	(51.2)	--	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	0.3	--	--	--	--
Revenue: Other (situational)	--	9.6	9.6	9.6	--	--	--	--
Dividends: Other	--	--	--	--	--	--	--	33.6
Total adjustments	(47.6)	9.6	9.6	9.9	0.0	(44.4)	(0.0)	33.6
S&P Global Ratings' adjusted amounts								
	Debt	**Revenue**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**
Adjusted	1,785.5	331.2	213.8	123.8	37.1	169.4	164.5	33.6

Liquidity

We view Elenia's liquidity as strong. We believe that available liquidity sources exceed our forecast of near-term cash outflows more than 2.7x in the next 12 months and more than 1.0x in the following 12 months.

In our liquidity assessment, we also factor in qualitative factors, such as Elenia's sound relationships with banks, very good standing in credit markets, and likely ability to absorb high-impact, low-probability events, with no debt maturities until 2026 and ample headroom under its financial covenants. We also perceive management as pro-active in its liquidity management, as evident in its spread-out debt maturity profile. The next material debt maturity of €140 million is not until 2026.

We forecast that Elenia will have significant headroom under both its covenants over the next two years. We also believe that the company has significant flexibility to reduce shareholder distributions even earlier to avoid reaching lock-up covenant levels.

Principal liquidity sources as of March 31, 2023:	Principal liquidity uses as of March 31, 2023:
• Forecast cash FFO of about €160 million. • Available cash and liquid marketable securities of about €87 million. • Access to committed credit lines of about €420 million.	• Capex of about €120 million-€130 million over the next 12 months. • About €140 million-€150 million of shareholder distributions that we view as flexible. • No debt maturities over the next 12 months.

Debt maturities

There are no debt maturities until the €140 million bond repayment in 2026.

Covenant Analysis

Elenia has two covenants--one on interest coverage and one on leverage (debt to EBITDA)--with two different triggers--a lock-up trigger for shareholder distributions of respectively 1.46x and 10.18x and a default trigger of 0.96x and 11.33x. 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. We view ample headroom of more than 400% for the interest coverage ratio and more than 25% for the leverage ratio annually.

A liquidity facility provided by suitably rated counterparties is available if Elenia enters a standstill, and is sufficient to cover finance charges for one year. The €70 million facility was undrawn as of June 13, 2023. The protective structure for bondholders not only includes covenants, but also limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on shareholder distributions.

We forecast that Elenia will have significant headroom over the next two years under both covenants. We also believe that the company has significant flexibility to reduce shareholder distributions even before reaching lock-up covenant levels (see table 4).

Table 4

Elenia's covenant triggers

	--Debt-to-EBITDA ratio--		--Interest coverage ratio--	
(x)	**Lock-up**	**Default**	**Lock-up**	**Default**
Covenant	10.18	11.33	1.46	0.96
Reported				
2022	8.69		5.21	
2021	8.22		5.52	
2020	8.84		4.68	
2019	8.65		3.55	

Environmental, Social, And Governance

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

ESG factors do not have a material influence on our credit rating analysis of Elenia. The company's network resilience has improved significantly, with fewer interruptions thanks to a greater amount of underground cabling.

Ratings Score Snapshot

Issuer Credit Rating: None

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)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile : bbb-

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings Detail (As Of June 13, 2023)*	
Elenia Verkko Oyj	
Senior Secured	BBB/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.