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Research Update:

Elenia Finance Oyj's Senior Secured Debt Upgraded To 'BBB+' From 'BBB' On Asset Sale And Supportive Financial Policy

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Rating Action Overview

- Elenia Group finalized the sale of its district heating business to a consortium of financial investors earlier this year for an undisclosed amount.
- The company has used the proceeds to repay all of its shareholder loans of about €165 million, and we understand it will use at least €225 million to repay external debt.
- In addition, Elenia is now committing to maintain its levels of adjusted funds from operations (FFO) to debt above 8% and debt to EBITDA below 9x, excluding the impact from International Financial Reporting Standards (IFRS) 15.
- We are raising our issue ratings on the senior secured debt issued by Elenia Finance Oyj to 'BBB+' from 'BBB'.
- The stable outlook reflects our understanding that the company has committed to maintain adjusted FFO to debt above 8% and adjusted debt to EBITDA below 9x, and to adjust dividend payouts to maintain the ratios.

Rating Action Rationale

The upgrade reflects the company's track record, debt reduction, and strengthening business risk profile. The upgrade further reflects our expectation that following the divestment of its district heating business in July 2019, Elenia will maintain FFO to debt at 9%-10% and debt to EBITDA at about 8.5x in 2020 and 2021. The company has a track record of operating with FFO to debt above 8%, and has committed to maintaining metrics at that level. After the divestment, Elenia's business mix marginally strengthened because it include almost entirely fully regulated power distribution activities in Finland. Higher-than-expected debt repayment, a less aggressive financial policy for 2019-2021, and repaying all shareholder loans during 2019 results in stronger FFO to debt and lower debt to EBITDA.

Elenia will use proceeds from the divestment of its district heating business to reduce debt. On July 1, 2019, Elenia agreed to sell Elenia Lämpö Oy to a consortium of financial investors for an undisclosed amount. Elenia Heat is the owner and operator of 16 local district heating networks in Finland, serving about 85,000 customers. The transaction was finalized July 22, 2019. We understand Elenia intends to repay at least €225 million of external debt and all of its shareholder loans. As per the company's report for first-half 2019, shareholder loans amounted to €165 million and carried an interest rate of 12%.

Regulatory reset risk is at its lowest, because a new regulatory period starts in 2020. We view the regulatory framework for 2016-2019 and for the fifth regulatory period (2020-2023) as stable and predictable. The methodology for calculating allowed profit has been in place since 2005, with only minor adjustments. The regulator implemented positive modifications in 2016 resulting in a higher weighted-average cost of capital (WACC) and stronger cost recoverability. The WACC is now linked to the higher of the 10-year average or previous year's (April-September) average of the Finnish government's 10-year bond. For the upcoming period, the regulatory methods will remain the same, however some of the parameters will be updated, for example the debt premium is adjusted to 1.26% from 1.40%. The risk-free rate is reset annually. WACC for 2020 is 5.73%, compared with 6.19% in 2019. Although WACC fell somewhat in the new regulatory period, we believe the framework is supportive and allows for good cost recoverability.

Elenia has a comfortable equity position after capital gains. We have previously excluded the shareholder loans from debt in our ratio calculations, reflecting their equity-like features such as subordination, and the possibility of deferring interest and treating it as equity. In 2018, Elenia Group reported negative equity of about €137 million. We expect it will now establish a comfortable equity position, with the resolution of its negative equity position, since it is our understanding that the divestment will result in tax-free capital gains in excess of €250 million.

Elenia Group's reorganization is ongoing. The company announced the reorganization on Nov. 4, 2019, and it requires creditor consent, through a Security Trust and Intercreditor Deed proposal. We understand final steps in the reorganization will take place in July 2020. We are awaiting final documentation to confirm it will not have credit implications.

Outlook

The stable outlook signifies that we expect to see steady earnings and credit metrics in the new regulatory period despite the falling WACC, 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. This could occur if the company increased investments and 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 would 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, and it is the second-largest electricity distribution operator behind Caruna in Finland, with 12% market share and a network of about 72,000 kilometers serving about 430,000 end users. In 2018, the company reported EBITDA of €194 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-issued debt includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Our Base-Case Scenario

In our base-case scenario (excluding Elenia Heat from July 31, 2019), we assume the following:

- Stable contribution from its predictable distribution system operator activities, supporting EBITDA generation with EBITDA margins at 58%-60% in 2019 and 65%-68% in 2020 and 2021.
- Capital expenditure (capex) of about €150 million annually over the coming two years.
- Bond repayment of about €400 million in 2019.
- The rest of the sale's proceeds to repay shareholder loans and fund other distributions to shareholders.
- A comfortable IFRS equity position.
- No material acquisitions.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures over 2019-2020:

- EBITDA at about €200 million in 2019, increasing to €210 million-€220 million in 2020.
- Debt to decrease in 2019 to about €1.6 billion, then to increase again to about €1.8 billion driven by debt-funded capex and dividends.
- FFO to debt of 8%-10% in 2019 and 2020, excluding the district heating business.
- Debt to EBITDA of 8.0x-8.5x in 2019 and 2020, compared with 9x in 2018.

Liquidity

We view Elenia's liquidity as adequate. We expect liquidity to remain adequate following the divestment. We believe that available liquidity sources (cash, committed credit facilities, and operating cash flow) should exceed 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 maintain adequate headroom under its financial covenants.

According to our calculations, Elenia's liquidity sources as of Sept. 30, 2019, comprise:

- Forecast FFO of about €150 million.
- Available cash and marketable securities of about €155 million.
- Access to committed credit lines of about €620 million.

Expected liquidity uses as of the same date include:

- Capex of about €160 million per year.
- Debt repayments of about €500 million in the next 18 months.
- An expected shareholder distribution of about €190 million.

Covenants

Elenia modified its covenants to mitigate IFRS15's effect on connection charge revenue. The impact is approximately 5% based on 2018 consolidated IFRS EBITDA. Over 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 at 11.33x, together with the interest-coverage ratio trigger at 1.46x and the interest-coverage ratio default at 0.96x.

Elenia continues to comply with its debt restriction covenants stipulated in its documentation. According to Elenia's calculations, as of June 30, 2019, the ratios were 9.02x and 3.89x, 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 Elenia has significant 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, should the group enter a standstill. This is sufficient to cover finance charges. The liquidity facility remained undrawn at June 30, 2019, and amounted to €60 million; and
- 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+/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

- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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, 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

Upgraded

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