

Research Update:

Finnish Network Electricity Operator Elenia Verkko Oyj 'BBB+' Issue Rating Affirmed; Outlook Stable

November 27, 2020

Rating Action Overview

- The EBITDA of Elenia Verkko Oyj's electricity network operations was €186 million in 2019 and will gradually increase to about €200 million in 2021 and €230 million in 2022 and we do not believe pandemic-induced downturns will substantially affect Elenia Verkko.
- The company benefits from the favorable operational environment in Finland, where 100% of its regulated activities are, with a very supportive regulatory framework, and also from increased investments in its regulatory asset base (RAB).
- Operating cash flows in 2020-2022 will continue to not cover capital expenditure (capex) and dividends, and adjusted debt will consequently also increase about €100 million–€200 million annually, despite higher operating cash flows, which still implies credit ratios in line with the rating, given funds from operations (FFO) to debt will remain around 8.5%-9.5%.
- Thanks to the company's ample liquidity situation, underpinned by the issuance in February, and its limited upcoming maturities, we have revised our liquidity assessment to strong from adequate.
- We are therefore affirming our 'BBB+' issue rating on the senior secured debt issued by Elenia Verkko Oyj.
- The stable outlook indicates that we expect stable operations and no significant changes to the regulatory framework during the current 2020-2023 period.

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Rating Action Rationale

We do not believe Elenia will suffer from the downturns related to the COVID-19 pandemic.

The company benefits from the favorable operational environment in Finland and thanks to this framework, which results in stable and predictable cash flows, we forecast that Elenia can keep FFO to debt at 8%-9% in 2020 and improve it to 9%-10% in 2021 and 2022. Nevertheless, we expect debt to EBITDA to reach 9.0x in 2020, before declining gradually to 8.5x in 2022. The restructuring completed in July 2020 should have very limited financial impact, nor do we expect any adverse tax impact on the group due to the restructuring.

We expect Elenia will show flexibility in shareholder distributions to maintain credit metrics commensurate with the rating, although we note that simplification of the group's structure will improve Elenia's ability to service its debt and return cash to the owners. The company appears committed to maintaining FFO to debt above 8% and debt to EBITDA below 9x, excluding the impact from International Financial Reporting Standard (IFRS) 15.

Discretionary cash flow (DCF) is negative because of investments and shareholder

distributions. We expect the deficit in aggregate will be about €165 million for 2021-2022. As a result, debt will likely increase by roughly the same amount by 2022. We foresee Elenia's S&P Global Ratings-adjusted debt at nearly €2 billion by the end of 2022, but at the same time we expect debt to EBITDA at around 8.5x.

Elenia submitted its electricity network development plan to Finland's Energy Authority in June 2020 with the target being to increase the underground cabling rate of the electricity distribution network to 75% by 2028. To meet this target, the company needs to continue to invest heavily, and it plans to invest a total of about €150 million annually in the coming years. We estimate this will, along with the generous remunerations to the owners, lead to a DFC deficit. The planned amount of dividends is about €190 million in 2020 and €90 million-€110 million in 2021, which takes a large bite of operating cash flow of €150 million-€175 million annually.

Elenia benefits from low risk, stable network operations within a framework we view as credit supportive.

We view Finland's regulatory framework 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, although 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% and 5.35% in 2021, compared with 6.20% in 2019. Although we expect a gradual decline in the current period, because the risk-free rate is declining and WACC reset annually, we believe the framework is supportive and allows for good cost recoverability.

It is our understanding that the government has proposed changes to the Electricity Market Act, which are up for approval in the parliament. According to the Energy Authority, the proposed changes mainly concern three factors--unit prices, WACC, and incentives--and could enter into force already in 2022, i.e., in the middle of a regulatory period. If changes are imposed in the middle of the period and result in a significant cut in remuneration, it could lead to a negative rating action. However, at this stage we expect the potential changes to have only a limited effect. Nevertheless, changes to the ongoing regulatory framework run contradictory to our view of regulatory stability.

Structural features in the senior secured debt continue to support the rating. The rating remains one notch above the senior secured debt's stand-alone credit profile thanks to various structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Elenia to manage temporary cash flow shocks. The debtholders benefit from the following features, which include, but are not limited to:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default.

- A liquidity facility available to draw on if the group enters a standstill, and is sufficient to cover finance charges. The liquidity facility amounts to €60 million.

Outlook

The stable outlook signifies that we expect to continue to see steady earnings and credit metrics in the new regulatory period, despite a 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 equity reported under IFRS.

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 rating could also come under pressure if the regulator imposes and implements a substantial change to the regulatory framework during the ongoing period (2020-2023) that would result in significantly lower remuneration, for example changing the risk-free rate component, and resulting in a lower WACC.

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 the company were to 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, however, given the group's business plan.

Company Description

Elenia's main business operation is electricity distribution. It is the second-largest electricity distribution operator in Finland behind Caruna, with a 12% market share. Its network of about 72,000 kilometers reaches about 430,000 end users. The group reported EBITDA of €183 million in 2019.

In February 2018, Elenia was acquired by Allianz subsidiaries and investment vehicles managed or advised by Allianz Capital Partners (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's issued debt includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Our Base-Case Scenario

- Finland's GDP to decline by about 6% in 2020, increasing by 2.5% in 2021 and 1.5% in 2022.
- Very limited impact from COVID-19 and related lockdowns.
- Stable contribution from predictable distribution system operator activities, with the next regulatory reset date in 2024, i.e., no changes to the framework in the existing period.
- Pre-tax WACC at 5.35%, 4.99%, and 4.76% for the years 2021, 2022, and 2023.
- Shareholder distributions of €180 million-€200 million during 2020, and €90 million-€110 million in 2021 and 2022.
- No material acquisitions.

Elenia Group -- Key Metrics

	2018§a	2019a	2020e	2021f	2022f
Mil. €					
EBITDA	195	183	190-210	220-240	220-240
FFO	147	105	140-160	170-190	180-200
Discretionary cash flow	(74)	(63)	(210)-(190)	(110)-(90)	(70)-(50)
Capital expenditure	159	166	150-180	130-160	140-170
Shareholder distributions¶	217	426	180-200	110-130	90-110
Debt	1,738	1,627	1,800-1,850	1,900-1,950	1,950-2,000
FFO to debt (%)	8.5	6.4	8.3-8.7	9.3-9.7	9.4-9.8
Debt to EBITDA (x)	8.9	8.9	9.0-9.2	8.4-8.6	8.4-8.6

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. §2018 include district heating business. ¶Shareholder distributions including: interest paid on shareholder loans, repayment of shareholder loans, dividends and upstream loans. All shareholder loans were repaid in 2019.

Liquidity

We view Elenia's liquidity as strong. We believe that available liquidity sources should exceed forecast near-term cash outflows by about 2.0x. In our assessment of liquidity, we view Elenia as having solid relationships with its banks and a high standing in credit markets, as demonstrated by the €500 million issuance in February, four bank facilities with a total undrawn amount of €510 million, and limited debt maturities in the next two years. We also assume that the company will maintain adequate headroom under its financial covenants because its regulated activities show limited volatility to EBITDA.

Principle liquidity sources as of Sept. 30, 2020, comprise:

- Available cash and marketable securities of about €275 million.
- Forecast FFO of about €180 million.
- Access to committed credit lines of about €510 million.

Principal liquidity uses over the same period comprise:

- Capex of about €150 million-€180 million over the next 12 months.
- Shareholder distributions of €140 million-€160 million.
- Debt repayment of €89 million

Covenants

Elenia has two covenants stipulating an interest coverage ratio and a leverage ratio (debt to EBITDA), with two different trigger ratios: a lock-up trigger (for shareholder distributions) and a default trigger.

	--Debt to EBITDA--		--Interest coverage ratio--	
	Lock-up	Default	Lock-up	Default
Covenant (x)				
	10.18	11.33	1.46	0.96
Reported ratio				
2020 H1 ratio (x)		8.37		4.24
2019 ratio (x)		8.65		3.55
2018 ratio (x)		8.87		4.05

Ratings Score Snapshot

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

Related Research

- Senior Secured Debt Of Elenia Finance (Elenia Verkko) Affirmed At 'BBB+' On The Group's Restructuring; Outlook Stable, June 26, 2020
- Elenia Finance Oyj's Senior Secured Debt Upgraded To 'BBB+' From 'BBB' On Asset Sale And Supportive Financial Policy, Nov. 25, 2019

Ratings List

Ratings Affirmed

Elenia Verkko Oyj

Senior Secured BBB+/Stable

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such

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criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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