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Ratings

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Elenia Finance Oyj

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Elenia Finance Oyj

Credit Highlights

None

Overview

Key Strengths	Key Risks
About 85% of operations in regulated electricity distribution, with stable and predictable revenues and cash flows.	Large portion of shareholder loans in the capital structure, with high levels of shareholder distributions.
Natural monopoly, one of the three largest electricity Distribution System Operator's (DSO) in Finland.	High leverage and with expectations of gradually weakening credit metrics resulting from a fully debt-funded capital expenditure (capex) program and high shareholder distributions.
Protective financing structure.	

We expect stable and predictable cash flow to continue from Elenia's fully regulated businesses. Its electricity distribution system operations (DSO) account for roughly 85% of EBITDA with the remaining 15% coming from its district heating business.

We anticipate Elenia to maintain its heavy capital expenditure (capex) plan. The capex plan is mainly focused on security of supply, which is stipulated by the Electricity Market Act 2013 by the Energy Authority requiring that by 2028 interruptions caused by storms should last a maximum of six hours in zoned areas and 36 hours in other areas.

We expect continued high shareholder distributions. Management has stated it would remain flexible to maintain the current rating.

We view the new owners as strategically aligned with management's strategy and company development. Allianz Capital Partners, on behalf of the Allianz Group, Macquarie Infrastructure and Real Assets, and VER (The Finish state pension fund), acquired Elenia in early 2018. We do not expect to see any change in the financial policy under the new owners.

Outlook

The stable outlook on Elenia reflects our expectations of the group's continued stable earnings and cash flows from its 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 on the debt, including S&P Global Ratings-adjusted funds from operations (FFO) to debt of at least 6%.

Downside scenario

Assuming no change to the business risk profile, we could lower the ratings should Elenia struggle to maintain adjusted FFO to debt of at least 6%, taking into account some variation in the annual regulatory surplus or deficit.

Upside scenario

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

Our Base-Case Scenario

Recent developments

Elenia's half-year 2018 results were in line with our forecast; with reported sales of €182 million, up from €173 million in 2017. Its EBITDA of €102 million was 5% higher than last year. These results corroborate our view of the sustainable business model characterized by stable and predictable cash flows.

Elenia is continuing with its sizable capex program emphasising the importance of weather proofing its networks through a combination of underground cabling and replacing overhead lines to secure uninterrupted electricity. Increasing the security of supply has been mandated by the government and Elenia believes the most efficient way to do this is by underground cabling. These investments have also contributed to an increased regulated asset base (RAB). The fairly large capex program, together with shareholder distributions, will proceed during the coming years and will add some pressure to credit metrics. In the first half of 2018 the total capex was €81 million compared to €73 million in the first half of 2017.

Elenia increased the network tariff by 9.9% on a pre-tax basis in August 2018 as part of its continued network improvement plan.

Assumptions

- EBITDA margins of about 55%-65% in the electricity distribution business.
- EBITDA margin in the district heating operations of about 30% in 2018 to 2020.
- Annual capex of about €145 million through 2020.
- Increasing leverage as a result of relatively aggressive shareholder distributions.
- Shareholder loans treated as equity.

Key Metrics

	2017A	2018E	2019E	2020E
EBITDA Margin	55	50-55	53-58	55-60
FFO/debt	9.6	7-9	7-9	7-9
Debt/EBITDA	8.0	9-10	9-10	9-10

FFO--Funds from operations. A--Actual. E--Estimate.

Base-case projections

Revenue growth in line with price increase. We expect Elenia to continue to raise tariffs over the coming years and in turn see revenue growth of roughly 6%-8% through 2020.

Stable adjusted EBITDA margins of around 55% through 2020. We believe that following a slight dip in EBITDA margin in 2018 Elenia will maintain its roughly 55%-60% margins.

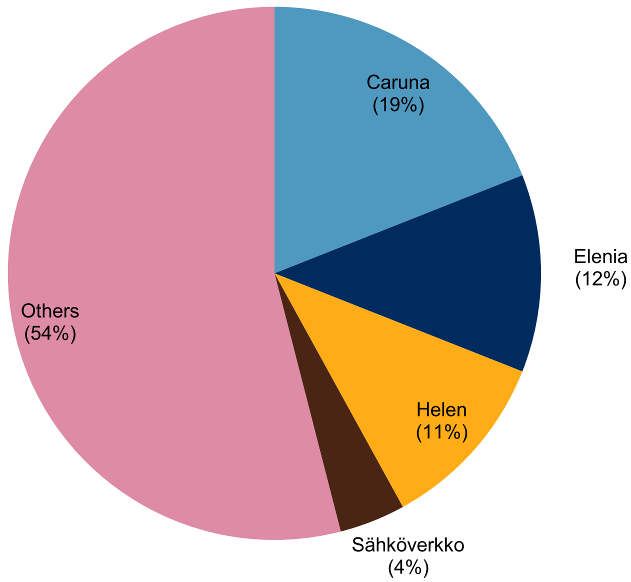
Shareholder loan (SHL) treated as equity. The SHLs have more than 10 years to maturity and the management has stated their intent to extend the maturity date of the non-common equity financing to at least 30 days after all the other debt matures and to repeat rollovers if necessary.

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. It also runs district heating operations, mostly based on own generation. 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.

Chart 1

Share of DSO Customers in Finland



Business Risk: Excellent

Elenia's business risk profile reflects the strength 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 network companies to be well-established, predictable, and supportive. We believe that the modifications to the framework for the regulatory period starting 2016 supported Elenia's credit profile, since they have increased the allowed regulatory return for the operators. The WACC for the period has increased to about 5.64% in 2017 on a post-tax basis and 7.05% on pre-tax basis, from about 3.1% (2015) in the previous period. The change was intended to support investments in the grids to renew the aged network and reduce outages, for example those caused by storms.

Following the distribution tariff increases announced by certain Finnish DSOs in 2016, the Electricity Market Act was amended in September 2017 restricting DSOs, including Elenia, from increasing their distribution tariffs by more than 15% (after taxes) over any rolling 12-month period. We understand, however, that this would not constrain Elenia's ability to fully obtain its regulatory allowed return.

We also note that, although the district heating business does not benefit from a similar regulatory framework, it 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.

Peer comparison

Table 1

Elenia--Peer Comparison

Industry Sector: Electric

	Elenia Finance Oyj*	Caruna Networks Oy	Ellevio AB
	--Fiscal year ended Dec. 31, 2017--		
(Mil. €)			
Revenues	342.3	426.4	708.7
EBITDA	188.1	270.0	440.8
Funds from operations (FFO)	145.4	217.3	282.5
Net income from cont. oper.	0.0	28.8	29.3
Cash flow from operations	101.4	123.5	211.5
Capital expenditures	146.3	293.5	241.1
Free operating cash flow	(44.9)	(170.0)	(29.6)
Dividends paid**	54.3	80.5	168.5
Discretionary cash flow	(99.1)	(250.4)	(198.1)
Cash and short-term investments	24.5	42.9	1.0
Debt	1,514.3	2,246.3	3,760.6
Equity	282.4	806.0	2,710.0
Adjusted ratios			
EBITDA margin (%)	55.0	63.3	62.2
Return on capital (%)	5.3	4.4	2.8
EBITDA interest coverage (x)	4.4	5.1	3.1
FFO cash int. cov. (X)	2.1	1.8	2.0
Debt/EBITDA (x)	8.0	8.3	8.5
FFO/debt (%)	9.6	9.7	7.5
Cash flow from operations/debt (%)	6.7	5.5	5.6
Free operating cash flow/debt (%)	(3.0)	(7.6)	(0.8)
Discretionary cash flow/debt (%)	(6.5)	(11.1)	(5.3)

*Figures for the consolidated Elenia Group. **Dividends paid include sharehold loan interest.

Elenia has a similar business risk profile to its Nordic peers, operating within a stable regulatory environment with historical transparency and predictability. Elenia is the second-largest DSO in Finland with a market share of 12% (Caruna has a 19% market share).

All three companies have large capex programs, and a large portion of shareholder loans. Elenia and Ellevio have a larger debt burden than Caruna compared with their earnings, and we view Caruna's financial risk profile as slightly stronger than Elenia's and Ellevio's. We expect FFO to debt for Elenia of 7%-9%, compared to Caruna at 9%-11%.

Financial Risk: Aggressive

Elenia's financial risk profile is constrained by high debt, and we expect its credit measures will slightly weaken. We anticipate that FFO to debt will deteriorate toward 7% over the next few years, from 9.6% at year-end 2017, and that the leverage ratio, debt to EBITDA, will remain below the covenant threshold at 10.18x. We assume that the group will increase debt under the capex facility to fund future investments, while distributing the vast majority of available cash flow to shareholders in the form of interest on subordinated loans ultimately from shareholders. We believe that there is limited incentive under the debt program's structure for Elenia to target credit measures that are materially stronger than the covenant levels.

In our assessment of Elenia's SACP, we also take into consideration that all of the shareholders' participation is in the form of subordinated loans, which--although we treat them as equity--indicate a more aggressive structure than one in which the shareholder participation is in the form of pure equity. We also acknowledge that the loans mature in more than 10 years and we believe that the issuer intends to extend the maturity date of the non-common equity financing to at least 30 days after all the other debt matures and to repeat rollovers if necessary.

Financial summary

Table 2

Elenia Finance Oyj* -- Financial Summary		
Industry Sector: Electric		
	--Fiscal year ended Dec. 31--	
	2017	**2016**
(Mil. €)		
Revenues	342.3	318.7
EBITDA	188.1	169.2
Funds from operations (FFO)	145.4	132.0
Net income from continuing operations	0.0	(15.4)
Cash flow from operations	101.4	67.1
Capital expenditures	146.3	125.3
Free operating cash flow	(44.9)	(58.2)
Dividends paid**	54.3	62.7
Discretionary cash flow	(99.1)	(120.9)
Debt	1,514.3	1,337.5
Equity	282.4	398.0
Debt and equity	1,796.6	1,735.5
Adjusted ratios		
EBITDA margin (%)	55.0	53.1
EBITDA interest coverage (x)	4.4	4.5
FFO cash int. cov. (x)	2.1	1.7
Debt/EBITDA (x)	8.0	7.9
FFO/debt (%)	9.6	9.9
Cash flow from operations/debt (%)	6.7	5.0

Table 2

Elenia Finance Oyj* -- Financial Summary (cont.)		
Industry Sector: Electric		
	--Fiscal year ended Dec. 31--	
	2017	**2016**
Free operating cash flow/debt (%)	(3.0)	(4.4)
Discretionary cash flow/debt (%)	(6.5)	(9.0)
Net cash flow/Capex (%)	62.3	55.3
Return on capital (%)	5.3	4.6

*Figures for the consolidated Elenia Group. **Dividends paid include sharehold loan interest.

Liquidity

We view Elenia's liquidity as adequate. 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 shareholder loan distributions 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 the 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.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments of about €80 million as of Sept. 30, 2018. • FFO of €160 million or more over the next 12 months. • €430 million available under credit facilities as of Sept. 30, 2018.	• Capex of about €150 million over the next 12 months. • Shareholder distributions, which we understand are undecided and flexible, but which we assume that on an annual basis would likely be in excess of €200 million.

Debt maturities

No debt maturities until 2020

Covenant Analysis

Elenia modified its covenants to mitigate the impact of the 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.

Covenant	Old Level	Adjusted Level
Leverage- Trigger	9.5	10.18

Covenant	Old Level	Adjusted Level
Leverage - Default	10.5	11.33
ICR - Trigger	1.7	1.46
ICR - Default	1.2	0.96

Compliance expectations

Elenia continues to comply with its debt restriction covenants stipulated in its documentation and as per our analysis below.

As of June 30, 2018, the ratios were 7.63x and 4.28x, respectively, showing significant headroom at both covenant levels, although we believe that headroom will reduce over the next 12 months, with the group estimating 9.15x and 3.95x at June 30, 2019. 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 also reflect various structural features designed to increase cash flow certainty for debtholders, including 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. 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 September 2018 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.

Other Credit Considerations

We view negatively the significant portion of, and payments on, the shareholder funds in the capital structure, which are in the form of shareholder loans. However, we exclude the loans from debt in our ratio calculations, reflecting their equity-like features such as subordination, and the possibility of deferring interest.

Reconciliation

Elenia's consolidated accounts are prepared under International Financial Reporting Standards. Our key analytical adjustments relate to shareholder loans, post-retirement benefit obligations, asset-retirement obligations and surplus cash. (see table 3).

Table 3

Reconciliation Of Elenia Finance Oyj* Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2017--							
Elenia Finance Oyj reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Dividends paid**
Reported	1,963.9	(144.0)	187.9	101.6	97.1	187.9	101.1	--
S&P Global Ratings adjustments								
Interest expense (reported)	--	--	--	--	--	(97.1)	--	--
Interest income (reported)	--	--	--	--	--	0.2	--	--
Current tax expense (reported)	--	--	--	--	--	(0.0)	--	--
Operating leases	0.3	--	0.4	0.0	0.0	0.3	0.3	--
Postretirement benefit obligations/deferred compensation	0.9	--	--	--	0.1	(0.1)	(0.1)	--
Surplus cash	(24.5)	--	--	--	--	--	--	--
Dividends received from equity investments	--	--	0.1	--	--	0.1	--	--
Non-operating income (expense)	--	--	--	0.2	--	--	--	--
Debt - Shareholder loans	(426.4)	--	--	--	--	--	--	--
Equity - Other	--	426.4	--	--	--	--	--	--
EBITDA - Income (expense) of unconsolidated companies	--	--	(0.2)	(0.2)	--	(0.2)	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	(0.1)	(0.1)	--	(0.1)	--	--
EBIT - Income (expense) of unconsolidated companies	--	--	--	0.2	--	--	--	--
Interest expense - Shareholder loan	--	--	--	--	(54.3)	54.3	--	--
Dividends - Other**	--	--	--	--	--	--	--	54.3
Total adjustments	(449.7)	426.4	0.2	0.1	(54.1)	(42.5)	0.3	54.3
S&P Global Ratings adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**
Adjusted	1,514.3	282.4	188.1	101.7	42.9	145.4	101.4	54.3

*Figures for the consolidated Elenia Group. **Sharehold loan interest

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
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb-

- Structural Enhancements: (+1 notch)

Related Criteria

- 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
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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

Related Research

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

Ratings Detail (As Of December 17, 2018)	
Elenia Finance 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.