Research Update:

Finnish Electricity DSO Elenia Verkko Oyj Debt Rating Affirmed At 'BBB' And Off Watch; Outlook Stable

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Rating Action Overview

- Finland's electricity regulator's final decision for the 2024-2031 regulatory period, published Dec. 29, 2023, includes updates to the methodology to value the regulated asset base (RAB) and to parameters to calculate the weighted average cost of capital (WACC); the changes to the methodology imply slower growth of the RAB for the new regulatory period and lower remuneration than in our previous forecasts.
- To mitigate the impact, the Elenia's board has approved measures including lower investments, tax payments, and shareholder distributions, which will enable Elenia to report funds from operations (FFO) to debt of 8.8%-9.0% over 2024-2026, which we view as commensurate with the rating. Elenia also expects to recover an accumulated regulatory deficit of €54 million, supporting EBITDA of €200 million-€220 million over 2024-2026.
- We therefore affirmed our 'BBB' rating on Elenia Verkko Oyj's senior secured debt, and removed the rating from CreditWatch negative where we placed it on Jan. 10, 2024.
- The stable outlook indicates that we forecast Elenia will operate with FFO to debt of 8.8%-9.0% over 2024-2026 despite uncertainties in the regulatory framework, refinancing risk in 2026, and a somewhat aggressive dividend policy.

Rating Action Rationale

The regulator's final decision for 2024-2031 results in slower asset base growth. Finnish electricity regulator the Energy Authority has published its criteria for this period, which started on Jan. 1, 2024. It includes three main elements that could have a significant credit impact on Finnish distribution networks:

- The existing asset base will be frozen at the 2024-unit price, with no adjustment for inflation at the end of the period.
- The unit prices will not be frozen for four years or asset base adjusted with inflation at the end

of the period, as has been the case previously. For investments made during 2024-2027 and 2028-2031, the unit prices will be inflation-adjusted for each of those years and will be based on the average construction cost incurred by the industry during the investment period. Network operators will know final unit prices at each end of the period, not the beginning as before. This may impact the distribution system operators (DSO)'s capital expenditure (capex) plans, possibly resulting in lower-than-expected spending, despite the government's carbon neutral goal by 2035.

- Unlike the October 2023 proposal, regulatory WACC remains based on median parameters and not on quartiles. It is confirmed at 7.37% for 2024, compared with the previously expected 6.9%.

Elenia's board has approved measures to keep FFO to debt higher than 8% over 2024-2026, a level we see as commensurate with the rating. In March, 2024, the board approved measures that should enable Elenia to maintain the IFRS adjusted FFO-to-debt ratio above 8% adjusted net debt to EBITDA below 8.75x at all times. Measures include:

- Tax optimization, resulting in no cash taxes to be paid over 2024-2027. We note this will increase tax liabilities, which might result in higher tax payments later.
- Capex to be reduced by €30 million-€40 million due to uncertainties around the RAB value as of year-end 2027 that might hinder growth we previously expected.
- Shareholder remuneration to be lowered, with a minimum dividend level of around €20 million-€30 million in 2024-2026, which supports Elenia's reported net debt to EBITDA remaining below 8.75x. We note that should there be headroom under the 8.75x target and shareholders might extract more dividends, as expected in 2024, at about €150 million-€160 million.

The above-mentioned measures should enable Elenia to report FFO of €170 million-€180 million, translating into FFO to debt of 8.5%-9.0% over 2024-2026, which we view as commensurate with the rating.

Furthermore, Elenia's regulatory deficit should help stabilize EBITDA over 2024-2027. As of end-2023, Elenia reported a regulatory deficit of about €50 million which Elenia plans to recover before end-2027 through a one-off tariff adjustment. This deficit comes from actual revenue in the previous period being lower than allowed income, per the regulation. We therefore expect Elenia's revenues to reach €330 million-€360 million annually, translating into EBITDA of €200 million-€220 million in line with 2021-2023 levels. As a result of the above-mentioned measures, we expect Elenia's credit ratios over 2024-2027 to be in line with our previous expectations published in our June 2023 report.

We also note that Elenia's FFO to debt is very sensitive to any setback, leading to reduced headroom. We therefore now assess the financial risk profile as highly leveraged rather than aggressive previously. Compared with our base case, should Elenia be required to pay its taxes, FFO would be reduced by €5 million-€10 million annually, translating into a 40-basis-point (bp) reduction of FFO to debt to 8.3%-8.6%. Depending on what interest rates the company can achieve in its upcoming refinancing, expected in 2026, we see a risk that FFO to debt could dip below the 8% threshold from 2027, which demonstrates the limited headroom. We note that Elenia plans to lower its shareholder distribution from €155 million to a minimum level of €20 million-€30 million--while we view this a positive we also note that there is not much flexibility to lower distribution further.

Elenia is exposed to a refinancing in 2026 when its €500 million benchmark bond comes due. We expect Elenia to refinance its €500 million benchmark bond in 2026 well ahead of its February 2027 maturity. We will monitor the refinancing, particularly regarding its 50% debt concentration limit requirement to benefit from the structurally enhanced debt features. These features currently lead to a one notch uplift to the stand-alone credit profile (SACP).

Outlook

The stable outlook reflects our expectation that Elenia's FFO will remain at €170 million-€180 million over 2024-2026, despite the regulatory changes that came into effect in 2022 and 2023. We continue to expect that Elenia's shareholder will adjust its shareholder distributions to protect its credit metrics if necessary. Therefore, we expect FFO to debt to remain around 8.5%-9.0%, and debt to EBITDA on average below 9x, which we consider commensurate with a 'bbb-' SACP.

Downside scenario

We could lower the rating to 'BBB-' if:

- Elenia's FFO to debt falls below 8% or debt to EBITDA rises above 9x without clear signs of recovery, which could occur because of much higher shareholder remuneration or investments than we expect.
- Unexpected negative changes to the 2024-2031 regulatory framework that could lead us to revise our assessment of Elenia's business risk profile.
- The supportive measures protecting the debtholders weaken.

Upside scenario

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.

Company Description

Elenia's main business operation is electricity distribution. It is the second-largest electricity DSO in Finland, behind Caruna Networks Oy. It has a 12% market share and a network of about 76,700 kilometers, serving about 438,000 end users. In 2023, Elenia's S&P Global Ratings-adjusted EBITDA reached €227 million, including 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. The financing group's issued debt includes structural enhancements designed to reduce the likelihood of default and the risk to creditors.

Our Base-Case Scenario

Assumptions

- Finland's GDP growth to increase 1.3% in 2024 and 1.5% in 2025.
- Pretax WACC at 7.37% for 2024, growing with higher cost of debt.
- EBITDA margins to be around 65%, in line with historical level.
- Limited working capital change annually over the forecast period.
- The company activates its cumulative allowed income (as of deficit to smooth the effect of the cut in RAV and lower WACC); that deficit is expected at about €50 million at year-end 2023.
- Shareholder distributions of about €150 million-€160 million in 2024, €30 million-€60 million afterwards although it is flexible to ensure that Elenia doesn't breach the IFRS adjusted 8.75x debt to EBITDA target.
- Capex of about €110 million-€120 million over the period, down from about €150 million.
- No mergers or acquisitions.

Key metrics

Elenia Vekko Oyj--Key metrics*

	--Fiscal year ended Dec. 31--				
Mil. €	2022a	2023a	2024p	2025e	2026e
EBITDA	214	227	210-230	200-220	200-220
EBITDA margin (%)	65	67	60-65	60-65	60-65
Funds from operations (FFO)	169	181	170-180	170-180	170-180
Capital expenditure	154	123	100-120	100-120	100-120
Dividends	34	154	150-160	20-30	60-70
Discretionary cash flow (DFC)	(1)	(5)	(5)-(4)	1-2	(1)-(0)
Debt	1,785	1,876	1,971	1,940	1,949
Debt to EBITDA (x)	8.4	8.3	<9	<9	<9
FFO to debt (%)	9.5	9.6	9.0-9.2	8.5-9.0	8.5-9.0

*All figures adjusted by S&P Global Ratings. a--Actual. p--Planned. e--Estimate.

Liquidity

We still assess Elenia's liquidity as strong because we believe available liquidity sources will cover sources by more than 2.2x over the 12 months started March 26, 2024, and by 3.6x the year after.

We also factor into our assessment 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 2027 as well as strong liquidity management as demonstrated by successful refinancing in the past, well in advance of maturities.

Elenia's liquidity sources over the 12 months from end-March 2024 comprise:

- Forecast cash FFO of about €160 million-€170 million.
- Available cash and marketable securities of about €60 million.
- Access to committed credit lines of €370 million.

Elenia's liquidity uses over the same period, comprise:

- Capex of about €110 million-€120 million over the next 12 months.
- About €150 million-€160 million of shareholder distributions.
- No debt maturities until 2026

Covenants

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 for both ratios 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 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.

Ratings Score Snapshot

Issue Credit Rating	BBB/Stable
Business risk:	Excellent
Country risk	Very Low
Industry risk	Very Low
Competitive position	Strong
Financial risk:	Highly Leveraged (medial table)
Cash flow/leverage	Highly Leveraged
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)

Issue Credit Rating	BBB/Stable
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb-

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Issue-Level Ratings Affirmed; Off CreditWatch

	To	From
Elenia Verkko Oyj		
Senior Secured	BBB	BBB/Watch Neg