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Ratings

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Elenia Verkko Oyj

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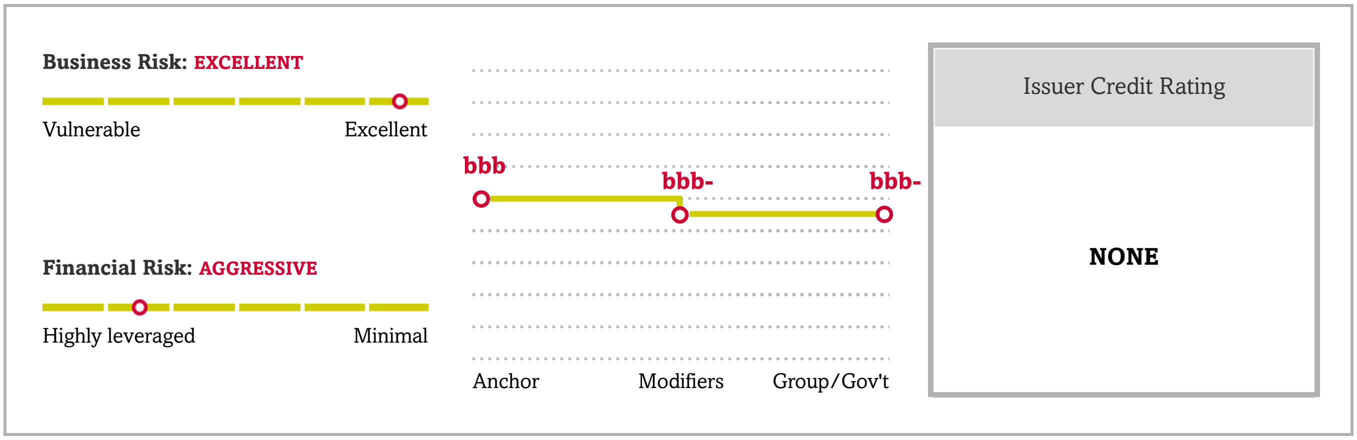


Credit Highlights

Overview

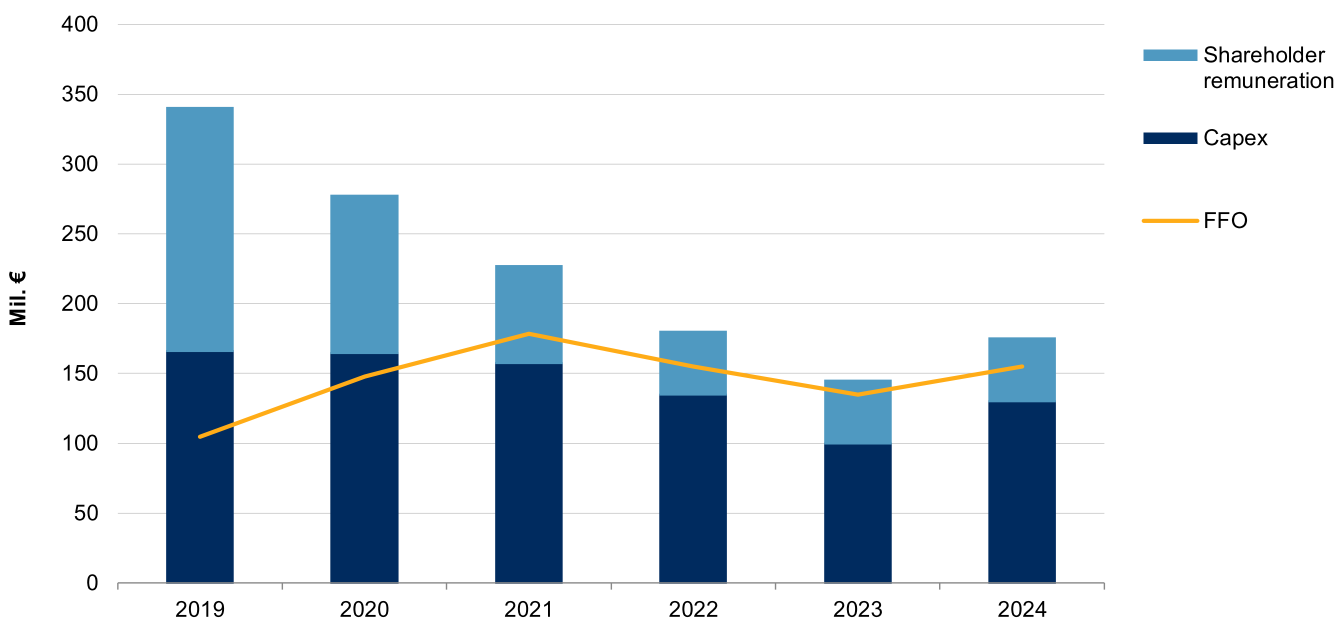
Key strengths	Key risks
A regulatory framework with supportive cost coverage that underpins stable cash flows via tariffs.	Uncertainty over the framework for the regulatory period starting 2024, which has not yet been communicated, and which could lead to lower remuneration for Finnish distribution system operators (DSOs).
Strong, monopoly-like position as Finland's second-largest electricity DSO, with our expectation of EBITDA of €180 million-€210 million annually in 2022-2024.	Elevated risk of political intervention to protect consumers from increasing energy bills, which could have a negative effect on Elenia's remuneration.
Our expectation that the owners will remain supportive and committed to maintaining funds from operations (FFO) to debt of close to 8%, which is commensurate with the rating.	High leverage, with S&P Global Ratings-adjusted FFO to debt of around 9% and debt to EBITDA below 9x on average over 2022-2024.
A protective financing structure, as debt includes structural enhancements that reduce the likelihood of default and the risk to creditors.	
Large operations and economies of scale, which imply higher-than-average operating efficiency.	

Elenia operates under a supportive regulatory framework, which, together with its operational efficiency, should continue to translate into healthy cash flows. We assess Finnish electricity DSOs as having a strong/adequate regulatory advantage, reflecting our view of the regulatory framework as supportive. Changes to the framework last year, in the middle of the regulatory period, prompted us to revise our assessment to strong/adequate from strong (see "Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts," published Oct. 29, 2021, on RatingsDirect. This is because of a negative track record of intervention in the framework during a set regulatory period, and this increases the uncertainty around future changes to the DSOs' compensation. Many DSOs have appealed the changes, but we understand that a court verdict is unlikely before the end of 2022. The changes resulted in an approximately 20% cut in Elenia's regulatory asset value (RAV) from 2022. This reduces the company's remuneration, as the remuneration is determined by the regulatory asset base and the weighted average cost of capital (WACC). However, the regulator allows full recovery of operating spending and capital expenditure. In addition, DSOs benefit from incentives on measures of quality, efficiency, investment, and innovation. The regulation has full pass-through of inflation, although the unit price list is usually only calibrated as a new regulatory period commences, and therefore the impact of inflation on ongoing projects is not fully averted. Overall, we consider the regulatory framework as supportive with solid cost coverage. Elenia's position as the second-largest DSO in Finland with a widespread network allows for economies of scale thanks to its operational efficiency and highly competent project management skills, which result in stable and predictable cash flows. We expect the EBITDA margin to remain at 60%-65% over 2022-2023.

We have limited visibility on any changes to the regulatory framework for the period starting 2024. We understand that the regulator could present a first draft at the beginning of 2023, and set the final terms in November of the same year. We do not expect significant changes to the framework, as the key changes were already implemented last year. Therefore, we expect that Elenia's FFO to debt will remain comfortably at 8%-10% and debt to EBITDA below 9x on average over 2022-2024, which we consider commensurate with a 'bbb-' stand-alone credit profile (SACP).

Chart 1

Elenia's Funds From Operations Do Not Fully Cover Capex And Shareholder Remuneration



Capex--Capital expenditure. FFO--Funds from operations. Source: S&P Global Ratings.

An ability to pass through costs ensures the stability of cash flows over time, but Elenia's high leverage makes its credit ratios sensitive to deviations in earnings on a yearly basis. We perceive Elenia's regulated activities as predictable, and the supportive cost coverage and ability to pass through costs as strengths. However, as market conditions are volatile, and with elevated electricity prices in Finland of about €144 per megawatt hour (/MWh) on average so far in 2022, compared to €74/MWh in 2021, the cost of grid losses could have a material effect on Elenia's EBITDA in the short term, despite the mitigating impact from hedges and the ability to recover costs in the long term. According to our estimates, grid losses could amount to about €30 million in 2022 and about €45 million in 2023. In 2021, grid losses amounted to €17 million. However, the negative impact should only be temporary, as grid losses are seen as pass-through costs in regulated earnings, and therefore Elenia can recover them in the coming years. Grid losses should therefore have a neutral effect on EBITDA on average. At the same time, Finland's transmission system operator Fingrid has announced a waiver of grid tariffs for December 2022 and an additional six months in 2023. This could have a positive effect on Elenia as the waived tariffs will offset the higher grid losses. We therefore believe that the overall impact of the grid losses and waived tariffs will be broadly neutral for Elenia's EBITDA in 2022 and 2023.

We forecast that leverage will slightly increase by the end of 2022. Debt could reach about €1.8 billion by the end of 2022, peaking at nearly €1.9 billion in 2023, especially if power prices remain unusually high. We do not expect this to imply a breach of covenants, as the company is allowed to exclude exceptionally high costs for grid losses from its covenant calculations and therefore can treat them as an extraordinary item. It is our understanding that Fingrid's waived tariffs are not included in the covenant calculations either. In our adjusted EBITDA calculation, we do not adjust for exceptional grid losses, as we believe that they are part of operational EBITDA and a consequence of structurally higher electricity prices. However, Elenia has the possibility to pass through the costs relating to these losses in full in the coming years, and in the short term, we expect the exceptional effect from grid losses for the most part to be netted from Fingrid's waived tariffs. We expect average debt to EBITDA to remain in line with the rating on average.

We believe that Elenia remains committed to keeping FFO to debt above 8%, and that it will maintain flexible shareholder remuneration to protect its ratios. Historically, Elenia's owners have been flexible about its financial policy, sizing shareholder remuneration to protect the credit ratios, which we believe will remain the case. For example, Elenia paid €70 million in dividends in 2021 due to the changes in the middle of the regulatory period that led to a significant cut in remuneration for all DSOs in Finland and reduced Elenia's RAV by about 20%. In contrast, in 2020, total shareholder remuneration exceeded €100 million. We expect shareholder remuneration to vary year on year, but remain in the range of €30 million-€70 million, which is lower than in previous years.

The senior secured debt has supportive features that lift the rating one notch. We rate the senior secured debt one notch above the SACP, thanks to the structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should enable Elenia to manage temporary cash flow shocks. Debtholders benefit from features that 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 €60 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: Stable

The stable outlook reflects our expectation that Elenia's FFO will remain in the range of €145 million-€165 million over

2022-2024, despite the regulatory changes that came into effect in 2022. We continue to expect that Elenia will use its flexibility to adjust shareholder distributions to protect its credit metrics if necessary. Therefore, we expect FFO to debt to remain comfortably at 8%-10%, 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. We view this as unlikely over the two-year outlook horizon, given the company's business plan and the recent changes to the regulatory framework that have led to lower remuneration. Elenia and most DSOs in Finland have appealed the changes imposed by the regulator. We could raise the rating if the appeal is successful. However, we understand that this could be a very lengthy process, and a positive outcome of the magnitude required for a return to a 'BBB+' rating appears unlikely at this stage.

Our Base-Case Scenario

Assumptions

- An increase in Finland's real GDP of 1.3% in 2022, 1.0% in 2023, and 1.7% in 2024.
- Costs relating to grid losses of about €30 million in 2022 and €40 million in 2023.
- Pretax WACC of 4.0% in 2022 and 6.08% in 2023.
- No material changes to the framework for the regulatory period starting in 2024.
- Activation of the company's €90 million cumulative allowed income deficit to flatten the effect from the cut in RAV and lower WACC.
- No mergers or acquisitions.

Key Metrics

Elenia OY Consolidated--Key Metrics

(Mil. €)	2021a	2022p	2023f	2024f
EBITDA	223.0	190-210	180-200	190-210
Funds from operations (FFO)	178.0	145-165	135-155	145-165
Capital expenditure	157.0	130-140	90-110	120-140
Shareholder remuneration	70	30-70	30-70	30-70

Elenia OY Consolidated--Key Metrics (cont.)				
(Mil. €)	2021a	2022p	2023f	2024f
Debt	1,767.0	1,750-1,850	1,800-1,900	1,800-1,900
Debt to EBITDA	7.9	8.5-9.0	8.7-9.2	8.0-9.0
FFO to debt (%)	10.1	8.5-9.5	8-9	8.5-9.5

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

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 75,500 kilometers, serving about 435,000 end users. In 2021, the company reported EBITDA of €223 million.

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--Nordic Peer Comparison			
	Elenia Verkko Oyj	Caruna Networks Oy	Ellevio AB
Rating as of Oct. 26, 2022	N/A	BBB/Stable	N/A
Issue ratings	BBB/Stable	N/A	BBB/BB+/Stable*
Business risk profile	Excellent	Excellent	Excellent
Country risk	Very low	Very low	Very low
Industry risk	Very low	Very low	Very low
Competitive position	Strong	Strong	Strong
Financial risk profile	Aggressive	Aggressive	Aggressive
Cash flow / leverage	Aggressive	Aggressive	Aggressive
Volatility table	Medial	Medial	Low
Anchor	bbb	bbb	bbb
Capital structure	Neutral	Neutral	Neutral
Liquidity	Strong	Strong	Strong
Financial policy	Neutral	Neutral	Neutral
Management / governance	Satisfactory	Satisfactory	Satisfactory
Comparable rating analysis	Negative (-1 notch)	Neutral	Negative (-1 notch)
SACP	bbb-	bbb	bbb-
SED§	+1 notch	N/A	+1 notch

Table 1

Elenia Verkko Oyj--Nordic Peer Comparison (cont.)			
*Ellevio's senior secured debt is rated 'BBB' and its subordinated debt is rated 'BB+'. §SED--Structural enhanced debt. N/A--Not applicable.			
Key financial hightlights (mil. €)			
Fiscal year ended	**Dec. 31, 2021**	**Dec. 31, 2021**	**Dec. 31, 2021**
Revenue	340.8	499.8	705.7
EBITDA	223.3	324.6	372.6
Funds from operations (FFO)	178.4	239.5	254.1
Interest expense	37.0	58.9	115.8
Cash interest paid	39.6	72.5	114.2
Cash flow from operations	188.6	184.6	364.0
Capital expenditure	157.2	138.9	349.1
Free operating cash flow (FOCF)	31.4	45.7	14.9
Discretionary cash flow (DCF)	(38.6)	(106.6)	14.9
Cash and short-term investments	71.8	60.8	1.2
Debt	1,767.0	2,545.5	3,884.4
Equity	(204.2)	663.6	3,141.8
Adjusted ratios			
EBITDA margin (%)	65.5	64.9	52.8
Return on capital (%)	8.9	6.1	2.9
EBITDA interest coverage (x)	6.0	5.5	3.2
FFO cash interest coverage (x)	5.5	4.3	3.2
Debt/EBITDA (x)	7.9	7.8	10.4
FFO/debt (%)	10.1	9.4	6.5
Cash flow from operations/debt (%)	10.7	7.3	9.4
FOCF/debt (%)	1.8	1.8	0.4
DCF/debt (%)	(2.2)	(4.2)	0.4

Financial summary

Table 2

Elenia Verkko Oyj--Financial Summary					
Industry sector: Electric					
	--Fiscal year ended Dec. 31--				
	2021	**2020**	**2019**	**2018**	**2017**
(Mil. €)					
Revenue	340.8	309.9	298.6	353.7	342.3
EBITDA	223.3	195.1	182.7	194.6	188.1
Funds from operations (FFO)	178.4	147.8	104.6	146.9	144.2
Interest expense	37.0	40.9	64.8	47.5	42.9
Cash interest paid	39.6	42.0	66.4	47.6	43.8
Cash flow from operations	188.6	164.7	118.9	119.6	101.5
Capital expenditure	157.2	164.4	166.1	158.7	146.3
Free operating cash flow (FOCF)	31.4	0.3	(47.2)	(39.1)	(44.8)

Table 2

Elenia Verkko Oyj--Financial Summary (cont.)

Industry sector: Electric

	--Fiscal year ended Dec. 31--				
	2021	**2020**	**2019**	**2018**	**2017**
Discretionary cash flow (DCF)	(38.6)	(112.7)	(221.4)	(73.8)	(87.3)
Cash and short-term investments	71.8	113.8	29.2	17.4	24.5
Gross available cash	71.8	113.8	29.2	17.4	24.5
Debt	1,767.0	1,731.0	1,627.3	1,737.6	1,514.3
Equity	(204.2)	(259.8)	219.7	115.2	282.4
Adjusted ratios					
EBITDA margin (%)	65.5	63.0	61.2	55.0	55.0
Return on capital (%)	8.9	6.9	5.4	5.8	5.8
EBITDA interest coverage (x)	6.0	4.8	2.8	4.1	4.4
FFO cash interest coverage (x)	5.5	4.5	2.6	4.1	4.3
Debt/EBITDA (x)	7.9	8.9	8.9	8.9	8.0
FFO/debt (%)	10.1	8.5	6.4	8.5	9.5
Cash flow from operations/debt (%)	10.7	9.5	7.3	6.9	6.7
FOCF/debt (%)	1.8	0.0	(2.9)	(2.2)	(3.0)
DCF/debt (%)	(2.2)	(6.5)	(13.6)	(4.2)	(5.8)

Reconciliation

Table 3

Elenia Verkko Oyj--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts

--Fiscal year ended Dec. 31, 2021--

Elenia Verkko Oyj reported amounts

(Mil. €)	Debt	Revenue	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Dividends
Reported	1,832.0	332.3	214.8	126.1	36.9	223.3	188.7	--
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(5.4)	--	--
Cash interest paid	--	--	--	--	--	(39.5)	--	--
Reported lease liabilities	3.1	--	--	--	--	--	--	--
Incremental lease liabilities	3.3	--	--	0.1	0.1	(0.1)	(0.1)	--
Postretirement benefit obligations/deferred compensation	0.4	--	--	--	0.0	--	--	--
Accessible cash and liquid investments	(71.8)	--	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	0.9	--	--	--	--
Revenue: Other	--	8.5	8.5	8.5	--	--	--	--
Dividends: Other	--	--	--	--	--	--	--	70.0

Table 3

Elenia Verkko Oyj--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (cont.)								
Total adjustments	(65.1)	8.5	8.5	9.5	0.1	(44.9)	(0.1)	70.0
S&P Global Ratings' adjusted amounts								
	Debt	**Revenue**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**
Adjusted	1,767.0	340.8	223.3	135.6	37.0	178.4	188.6	70.0

Liquidity: Strong

We view Elenia's liquidity as strong. We believe that available liquidity sources exceed our forecast of near-term cash outflows by more than 2x in the next 12 months and more than 1x 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.

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 Sept. 30, 2022:

- Our forecast of FFO of about €130 million-€140 million for the coming 12 months.
- Available cash and marketable securities of about €81 million.
- Access to committed credit lines of about €510 million.

Principal liquidity uses as of Sept. 30, 2022:

- Capex of about €110 million-€120 million over the next 12 months.
- About €30 million-€70 million of shareholder distributions.
- 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 and a default trigger. 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.

A liquidity facility provided by suitably rated counterparties is available if Elenia enters a standstill, and is sufficient to cover finance charges. The €60 million facility was undrawn as of Sept. 31, 2022. 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				
2021	8.22		5.52	
2020	8.84		4.68	
2019	8.65		3.55	

According to Elenia's calculations, as of Dec. 30, 2021, the ratios were 8.84x and 4.68x, respectively, showing headroom at both covenant levels, and we believe that headroom will continue to increase.

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

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	Significant	**Aggressive**	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	**bbb**	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of October 26, 2022)*

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.