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Summary:
Elenia Finance Oyj

Primary Credit Analyst:
Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@standardandpoors.com

Secondary Contact:
Mikaela Hillman, Stockholm (46) 8-440-5917; mikaela.hillman@standardandpoors.com

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Summary:

Elenia Finance Oyj

Secured Debt
• Long-term issue rating: BBB

Rationale

Business Risk	Financial Risk
• About 85% of operations in regulated electricity distribution, with stable and predictable revenues and cash flows. • About 15% of operations in district heating with a natural monopoly position in the catchment area, although there are some volume and commodity risks. • Some relative weaknesses regarding recovery of costs in the event of extraordinary weather conditions.	• An aggressive financial policy, under which all free cash is distributed to shareholders. • High debt, and expectations of gradually weakening credit metrics resulting from a fully debt-funded capital expenditure program and high shareholder distributions. • Flexibility to adjust shareholder distributions to unexpected deterioration of cash flows. • Credit-supportive structural features.

Underlying Outlook

Standard & Poor's Ratings Services' view of the underlying credit quality of Finnish electricity distribution and district heating group Elenia, and related entity Elenia Finance Oyj, reflects its expectations of continued stable earnings and cash flows from the group's 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 'BBB' ratings on Elenia Finance's secured debt, including adjusted funds from operations (FFO) to debt of at least 6%.

Downside scenario

Rating downside could result from any unfavorable changes to the Finnish regulatory framework for electricity distribution operators. This could lead us to review Elenia's excellent business risk profile, and as a consequence, we could revise our assessment of its underlying credit quality downward. In addition, we could lower the ratings should Elenia struggle to maintain adjusted FFO to debt of at least 6%, taking into account some variation with regard to the annual regulatory surplus or deficit. A negative rating action could also follow should Elenia group enter into significant super-senior hedges, because this could weaken the position of senior creditors in a financial stress scenario.

Upside scenario

Given our assessment of high leverage and relatively weak credit metrics, combined with an aggressive financial policy, we see limited rating upside at this time. However, we could consider raising the ratings if Elenia's financing structure 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.

Standard & Poor's Base-Case Scenario

The main rating constraint is the high level of debt, which results in relatively weak cash flow debt-coverage metrics. In our base case, we expect that Elenia will report higher earnings from its regulated electricity distribution business, following the expected increase in the regulatory allowed return from 2016. However, we expect that substantially all of the free operating cash flows will be distributed to shareholders. Consequently, we forecast that Elenia's adjusted ratio of FFO to debt will gradually weaken to about 7% over the next few years from about 11% in 2014.

Assumptions

- An increase in the the distribution business' EBITDA margin to about 56%-62% in 2016 from about 48%-53% in 2015, reflecting the regulator's proposed modifications to the pre-set weighted average cost of capital formula from 2016 and modest growth of the asset base.
- For the district heating operations, an EBITDA margin of 25%-27%.
- Annual capital expenditure (capex) of about €100 million over 2015-2016.
- Increased leverage as a result of relatively aggressive shareholder distribution.

Key Metrics

	2014	2015e	2016e
FFO to debt (%)	10.7	7.5-9.5	7.5-9.5
Debt to EBITDA (x)	7.1	7.5-9.0	8.5-9.5

Fully Standard & Poor's adjusted. Shareholder loans of €651 million treated as equity in ratio calculations. e--Estimate.

Business Risk

We base our view of the Elenia group's excellent business risk profile mainly on our assessment 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 likely modifications to the framework for the regulatory period starting 2016 will increase the allowed regulatory return for operators, including Elenia, which is credit supportive.

There are, however, relative weaknesses regarding recovery of costs in the event of extraordinary weather conditions, although such events as rare and therefore the related risk is sufficiently contained. We also note that the district heating business does not benefit from a similar regulatory framework, but 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.

Financial Risk

Elenia's financial risk profile is pressured by high debt and our expectation of weakening credit measures. We anticipate that FFO to debt will deteriorate toward 7% over the next few years and that debt to EBITDA will be close to the 9.5x covenant threshold over most of the life of the transaction. We assume that the company will increase debt under the capex facility to fund future investments, while distributing all available cash flow to shareholders in the form of interest on or repayment of shareholder loans. Our forecast is further supported by the limited incentive under the program's structure for Elenia to target debt-protection measures that are materially higher than the covenant levels.

We also take into consideration that all of the shareholders' participation is in the form of shareholder loans, which although we treat them as equity, indicates a more aggressive structure than one in which the shareholder participation is in the form of pure equity.

Liquidity

We view Elenia's liquidity as adequate. We estimate that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow will be above 1.1x of 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 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. We also note that the capex facility, which accounts for €171 million of the €276 million in available facilities, can be used for capex and acquisitions only and not for shareholder distributions.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments of about €11 million as of Sept. 30, 2015. • Adjusted FFO of about €100 million or more over the next 12 months. • €276 million available under credit facilities as of Sept. 30, 2015, of which €171 million is under the capex facility.	• Capex of about €100 million per year in 2016 and 2017. • Shareholder distributions, which we understand are undecided and flexible but assume will likely be in excess of €60 million annually on average.

Other Credit Considerations

The ratings on Elenia Finance's notes also reflect various structural features in the notes that, in our view, increase cash flow certainty for debtholders. These include payment restrictions and a covenanted liquidity structure that we believe should allow Elenia to manage temporary cash flow shocks and keep secured creditors in a strong position should the group fall into financial difficulty. On the other hand, in our view, the notes' structure and the Finnish regulatory environment are less robust than in other markets.

Related Criteria And Research

Related Criteria

- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012

Related Research

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

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com