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Research Update:

Swedish Electricity Distributor Ellevio's Senior Secured Debt Affirmed At 'BBB'; Outlook Stable

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Overview

- Ellevio AB continues to post solid operating results, benefitting from a supportive regulatory framework.
- We forecast stable credit measures as increasing funds from operations are likely to be offset by high capital expenditures and shareholder returns.
- We are affirming our 'BBB' issue credit rating on Ellevio's senior secured debt.
- The stable outlook reflects our forecast that Ellevio will continue to generate steady, predictable earnings, and maintain credit measures in line with the current rating, including funds from operations to senior secured debt of at least 6%.

Rating Action

On Aug. 25, 2017, S&P Global Ratings affirmed its 'BBB' issue credit rating on the senior secured debt issued by Swedish electricity distribution system operator Ellevio AB. The outlook is stable.

Rationale

The affirmation reflects Ellevio's continued solid operating results, which benefit from what we view as a strong regulatory framework for electricity distribution networks in Sweden. Ellevio (formerly Fortum Distribution Sweden) is the second largest electricity distribution network operator in Sweden, operating in four regions, and it has an 18% market share. In 2016, the company reported EBITDA of about Swedish krona (SEK) 3.9 billion (about €0.4 billion).

We anticipate growth in EBITDA and funds from operations (FFO) over the next few years, relating to price increases, a growing asset base, and the acquisition of Nynäshamn Energi (a regulated distribution network) in late 2016 that Ellevio has consolidated in 2017. We expect, however, that FFO to debt will stay at 7.5%-8.0% through 2019 because we anticipate Ellevio will continue investing heavily in its network, as well as returning substantial cash to shareholders, primarily through payments on shareholder loans.

We also view the ongoing legal dispute between the regulator and the distribution system operators (DSOs) about the weighted average cost of capital (WACC) for the current regulatory period 2016-2019 as a source of some uncertainty. However, during the last court proceedings regarding the WACC for the regulatory period 2012-2015, the court ruled in favor of the DSOs. On Dec. 14, 2016, the administrative court decided the WACC should be set at 5.85%, which the regulator has appealed because it believes this is an unfair return in such a low-risk environment. That said, Ellevio has the ability to raise tariffs on the back of deficits from the previous regulatory period, which adds to stability of cash flows.

The 'BBB' rating on the debt reflects our assessment of Ellevio's 'bbb-' stand-alone credit profile (SACP) plus one notch of uplift for structural enhancements.

In our view, Ellevio's business risk profile benefits from fully regulated electricity distribution operations, with natural monopoly positions in its service areas. We view the Swedish regulatory framework for electricity distribution as stable, transparent, and predictable, with a long track record. This is despite some modifications in methodology between regulatory periods, and minor weaknesses relating to customer compensation in the event of longer unplanned outages.

We view as positive the preset regulatory allowed rate of return on capital (that is, the WACC rate) for the full four-year regulatory period, as well as operators' ability to adjust tariffs at any time and carry over regulatory surpluses or deficits to the next regulatory period, which supports stable cash flows. We also believe the allowed return adequately covers operating and capital costs. We recognize that the negative effect on capital compensation, due to the transition to an age-adjusted model for regulatory asset value for the regulatory period 2016-2019, will be partly mitigated by the introduction of an age-floor for old assets.

We see potentially high customer compensation in case of outages for more than 12 hours as a minor regulatory weakness. However, due to high cabling and weatherproofing rates, Ellevio's exposure is very limited. We also recognize that the regulatory framework does not cover capital expenditures (capex) during construction, but only once the assets are in operation. Nevertheless, because the regulated asset base (RAB) is updated every six months, there is no major time lag before assets become part of the RAB.

Although Ellevio is one of the largest DSOs in Sweden, it is smaller than several of its international peers. Ellevio has good customer and geographic diversity, which reduces risks related to unplanned outages, due for example to weather conditions. We also believe that Ellevio's operating efficiency and profitability are broadly in line with its major peers'.

We view as negative that a significant portion of the shareholder funds in the capital structure is in the form of shareholder loans. However, we exclude these loans from debt in our ratio calculations, reflecting their equity-like features, such as deep subordination, longer tenors than all other debt, and the possibility to accrue interest. We also acknowledge, however, that

Ellevio's credit measures are at the weaker end of the range for the financial risk category.

In our base case, we assume:

- Price increases during the current regulatory period (2016-2019) to reduce Ellevio's regulatory deficit in 2012-2015. We also note that, following an appeal from the Swedish DSOs, the Swedish administrative court set the WACC at 5.85% for the current regulatory period, which is above the regulator's predetermined WACC of 4.53%. The court's judgement is pending appeals.
- Capex of about SEK2.4 billion-SEK2.7 billion annually over the next two years.
- Shareholder returns of about SEK1.2 billion in the next few years, which we assume will be flexible if needed to sustain credit measures.

Based on these assumptions, we arrive at the following credit measures, based on Ellevio's senior secured debt:

- FFO to debt of 7.5%-8.0%.
- Debt to EBITDA of 8.5x-9.0x.

We also note that covenants, both for lock-up and default events, would allow higher leverage than we currently forecast in our base case. At the same time, we note that capex should be added to the RAB and therefore increase the allowed regulatory return. We also understand that the company's shareholder returns are flexible and can be reduced if needed to preserve credit ratios (before reaching dividend lock-up levels).

Liquidity

We now assess liquidity as strong, based on Ellevio's adequate headroom under all its financial covenants and available liquidity sources likely being well in excess of 1.5x liquidity uses over the next 12 months. We assume that sources will continue to cover uses even if EBITDA declines by 30% from our base case.

We also acknowledge Ellevio's track record in the capital markets over the past year, which leads us to regard its market access as high rather than satisfactory, and bank relationships as solid rather than sound. We do not see Ellevio's liquidity position as exceptional because we believe that headroom under its capex facility will gradually reduce as the expansionary investment program progresses.

Principal liquidity sources as of June 30, 2017, include:

- Cash of about SEK55 million;
- FFO of SEK2.5 billion-SEK2.7 billion over the next 12 months; and
- About SEK8.3 billion available under bank lines of about SEK9.3 billion, comprising a SEK8.1 billion capex facility and SEK1.2 billion working capital facility, both maturing in May 2020.

Ellevio also has a super senior liquidity facility of SEK1.5 billion, which is intended for use only during a potential 12-month standstill period. We therefore do not include this facility in liquidity sources for ongoing outflows.

The principal liquidity uses consist of:

- Amortizing debt maturities of about SEK0.9 billion over the next 12 months;
- Annual capex of SEK2.4 billion-SEK2.7 billion; and
- Roughly SEK1.2 billion of shareholder returns annually.

Financial covenants

The credit facility contains covenants for lock-up and default stipulating debt to EBITDA of 10.75x and 12.0x, respectively, and interest cover of 1.7x and 1.2x. Ellevio complies with the debt-maturity limitations in the documentation, and has complied with all of its financial covenants in the past. Based on our forecasts, we believe Ellevio will have comfortable headroom under its financial covenants over the next few years.

Structural enhancements

Ellevio is the operating company in the Ellevio group, which includes four holding companies. The ultimate owners are international investor Borelais, two Swedish national pension funds (AP3 and AP1), and Swedish mutual insurance company Folksam. Following debt refinancing, Ellevio and its immediate holding company Ellevio Holding 4 AB have formed a ring-fenced financing structure, with Ellevio as the borrower. We rate Ellevio's senior secured debt one notch higher than Ellevio's SACP because of structural features designed to increase cash flow certainty for the debtholders. These features include:

- Restrictions on mergers, acquisitions, and asset disposals, and a share pledge over the assets and shares of the operating and holding company (to the extent allowed by legislation). Security over fixed assets, such as real property, and business mortgages are however not material in relation to secured debt.
- Dividend- and debt-restricted payment conditions and a covenanted liquidity structure that should, in our opinion, allow Ellevio's financing group to manage temporary cash flow shocks.
- An automatic 12-month standstill period after an event of default, during which time creditors can take control of Ellevio and either aim for operational recovery or sell the shares in the operating and immediate holding company.
- Prudent management of foreign exchange, refinancing, and counterparty risks.

Outlook

The stable outlook on Ellevio's senior secured debt reflects the company's stable and predictable earnings, which are supported by a favorable regulatory framework. We anticipate that Ellevio will maintain credit measures in line with the current ratings, including FFO to senior secured debt of at least 6%.

Upside scenario

We currently see limited potential for a positive rating action, owing to our view of Ellevio's financial policy and covenant structures. However, we could raise the rating if credit measures permanently strengthened, reinforced by the group's financial policy, resulting in a ratio of FFO to debt sustainably above 8%.

Downside scenario

A negative rating action would primarily relate to any unexpected adverse changes to the regulatory framework that could cause earnings volatility or deterioration and weigh on Ellevio's credit measures. Material acquisition activity or excessive shareholder returns could also lead us to lower the rating, for example, if this caused FFO to debt to decrease to below 6% for a prolonged period.

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: 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

- 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 - General: Corporate Methodology: Ratios And Adjustments, 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: 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

Ratings List

Ratings Affirmed

Ellevio AB	
Senior Secured	BBB/Stable

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