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Research Update:

Swedish Multi-Utility Kraftringen Energi AB 'BBB+' Ratings On CreditWatch Negative On Skanska Energi Acquisition

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Overview

- On Nov. 6, Kraftringen Energi AB announced that it has increased its total stake in Skånska Energi AB to 63% from 10%. The company has financed the Swedish krona (SEK) 323 million (€31.3 million) acquisition with a SEK500 million (€48.4 million) short-term bank back-up facility, which could lead to weakening liquidity.
- Although we expect Kraftringen's credit metrics to weaken following the acquisition, we expect the ratio of funds from operations (FFO) to debt to exceed 23% in 2018-2020, which is our threshold for the rating.
- We are placing our 'BBB+' ratings on Kraftringen on CreditWatch negative.
- We aim to resolve the CreditWatch within the coming months depending on Kraftringen's progress in refinancing its short-term debt.

Rating Action

On Nov. 23, 2018, S&P Global Ratings placed its 'BBB+' long-term and 'A-2' short-term issuer credit ratings on Sweden-based multi-utility Kraftringen Energi AB on CreditWatch with negative implications. We also placed on CreditWatch negative our 'K-1' short-term Nordic regional scale rating and our 'BBB+' issue rating on Kraftringen's senior unsecured debt.

Rationale

The CreditWatch placement reflects the potential weakening of Kraftringen's liquidity following the acquisition of Skånska Energi AB for SEK323 million, which the company has fully funded with short-term debt. We understand that Kraftringen has drawn SEK360 million under its Svenska Handelsbanken (SHB) short-term back-up facility maturing in December 2019 to fund the acquisition.

As of the completion of the acquisition, we calculate that Kraftringen's long-term sources of liquidity are approximately equal to its liquidity needs for the next 12 months. For a regulated utility with an investment-grade stand-alone credit profile, we would normally anticipate at least 10% excess liquidity reserves. We estimate that right after the acquisition, sources of liquidity include zero cash balances, SEK940 million committed long-term bank lines (SEK500 million long-term bank facility maturing in 2020, SEK140 million

backup line maturing in December 2019, and SEK300 million revolving credit facility maturing in 2021) and expected funds from operations (FFO) of about SEK500 million annually. Key uses of liquidity include sizable SEK990 million short-term debt maturities, maintenance capital expenditure (capex) of about SEK400 million (about 80% of total capex planned), and about SEK100 million annual dividends. We understand that the company plans to refinance the acquisition-related short-term bridge facility as well as other short-term debt, and we will monitor refinancing progress.

We believe the company will be able to accommodate higher post-acquisition leverage within the current rating, with FFO to debt above our 23% threshold. Still, the Skånska Energi acquisition has used up the rating headroom that previously existed. We anticipate that the company's FFO-to-debt ratio will decline from about 32% in 2017 to 23%-25% in the next two years, and potentially above 25% going forward.

We expect Kraftringen's EBITDA to increase by about 8% following the integration of Skånska Energi, and we anticipate that Kraftringen's stable cash flow generation from district heating and electricity distribution will continue. The electricity distribution activities currently represent approximately 40%-45% of the company's EBITDA. We expect the upcoming regulatory period (2020-2023) for electricity distribution system operators (DSOs) will not materially impact Kraftringen, even though initial estimates indicate a weighted-average cost of capital (WACC) of 3%, down from the current level of 5.85%. This is due to a recent court ruling in Sweden allowing DSOs to carry under-recovered revenues from the first regulatory period through to the third, which is positive for Kraftringen because they have a large surplus that they can now carry forward. They have not been increasing prices as much as some other DSOs in Sweden.

Skånska Energi is a fairly small neighboring multi utility, which generates all of its EBITDA from its DSO activities. In 2017, Skånska Energi had an EBITDA of SEK56.5 million, compared with Kraftringen's EBITDA of SEK680 million in 2017. Kraftringen's other business activities include energy trading, energy production, energy solutions, and corporate activities.

We view Kraftringen's acquisition of Skånska Energi as strategic. It is in line with Kraftringen's business model and has the potential to create synergies. That said, Infranode's recent acquisition of 23% of Skånska Energi's shares could prolong the time it takes to achieve maximum synergies. Our base-case scenario does not factor in any material change in Skånska's shareholding structure.

In our opinion, Kraftringen's business risk profile reflects its operations in a very stable country and the very low-risk industry sectors of regulated electricity distribution and stable district heating, which together make up approximately 80% of its EBITDA.

Our base case (incorporating Skånska Energi from 2019) assumes:

- Relatively stable electricity and heating production and fuel costs to

support EBITDA generation of roughly SEK660 million in 2018. In 2019-2020, we expect EBITDA to increase to about SEK800 million, reflecting the full consolidation of Skånska Energi AB.

- Capex of around SEK580 million in 2018 decreasing to SEK480 million in 2019.
- Acquisition costs of SEK323 million for 53% of shares in Skånska Energi.
- Shareholder distributions of about SEK100 million per annum.
- No material acquisitions.

Based on these assumptions, we arrive at the following credit measures:

- Pro forma FFO to debt of 23%-25% through 2019, incorporating the transaction; and
- Debt to EBITDA between 3x-4x in 2018 and 2019.

CreditWatch

The CreditWatch placement indicates that we could lower the ratings if Kraftringen fails to refinance its sizable short-term debt with longer-term funding. If liquidity remains less than adequate, this could lead us to revise down our assessment of Kraftringen's stand-alone credit profile to 'bb+' from 'bbb-' and lower the rating by one notch. If Kraftringen manages to refinance, so that its liquidity sources exceed liquidity needs by more than 10% for the next 12 months, we are likely to affirm the rating. At this stage, in the absence of additional acquisitions or shareholder distributions, we believe that additional leverage resulting from the acquisition is unlikely to pressure the rating.

We aim to resolve the CreditWatch within the next three months, depending on the company's progress with its refinancing plans for the currently drawn back-up facility from SHB and the resulting impact on Kraftringen's liquidity position.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The

Unregulated Power And Gas Industry, March 28, 2014

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 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; CreditWatch/Outlook Action

	To	From
Kraftringen Energi AB (publ)		
Issuer Credit Rating	BBB+/Watch Neg/A-2	BBB+/Positive/A-2
Nordic Regional Scale	--/Watch Neg/K-1	K-1
Senior Unsecured	BBB+/Watch Neg	BBB+
Commercial Paper	K-1/Watch Neg	K-1

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