

Research Update:

Swedish Multi-Utility Kraftringen Upgraded To 'A-' On Improved Operating Efficiency, Continued Deleveraging Commitment

May 12, 2021

Rating Action Overview

- Kraftringen Energi AB (publ) showed improved operating efficiency and reported record high EBITDA at Swedish krona (SEK)832 million, which it used to reduce debt reduction by almost SEK300 million in 2020, despite the very challenging warmer weather, extremely low power prices, and the pandemic.
- Despite these factors, table and predictable electricity distribution system operator (DSO) activities and district heating revenue and the company's commitment to deleveraging have spurred steady improvements in Kraftringen's credit ratios, a trend we expect will continue over the coming two years.
- We have therefore raised our long-term issuer credit rating on Kraftringen to 'A-' from 'BBB+' and affirmed the 'A-2' short-term issuer credit rating and the 'K-1' Nordic regional scale rating.
- The stable outlook reflects our understanding that the company is committed to deleveraging, and that we expect funds from operations (FFO) to debt at about 35%-40% during 2021-2023.

PRIMARY CREDIT ANALYST

Daniel Annas
Stockholm
+46 (8) 4405925
daniel.annas
@spglobal.com

SECONDARY CONTACT

Per Karlsson
Stockholm
+ 46 84 40 5927
per.karlsson
@spglobal.com

Rating Action Rationale

The upgrade reflects our expectations of increased earnings and cash flow in 2021 and 2022, leading to sustained lower debt and improved credit ratios. The company increased its EBITDA by almost 30% in 2020 versus 2018 levels, which supported a healthy debt reduction of 17% to about SEK2.1 billion from SEK2.6 billion in 2018. This debt reduction has been more rapid than we had anticipated after Kraftringen's acquisition of an increased stake of Skånska Energi in 2018 for about SEK320 million. Kraftringen currently owns about 72% of Skånska Energi and its contribution to consolidated EBITDA during 2020 was SEK64 million.

During 2020, Kraftringen's EBITDA margin improved to 24% compared with 20% in 2018, despite the very challenging conditions of a warmer than usual winter, an extremely low electricity price, and the pandemic. This was facilitated by:

- Kraftringen starting its low-heat district heating services;
- The increased capacity in two of its combined heat and power plants;
- Synergies and consolidation of Skånska Energi;
- Improved margins in its district heating activities thanks to the lower demand for heat that resulted in lesser requirement for higher-priced fuels.

We expect EBITDA to continue to increase, boosted by further operating efficiencies, increased capacity in district heating, and additional synergies in its DSO business from the Skånska Energi stake, allowing for further debt reduction. For 2021 and 2022 we now see increased FFO of about SEK750 million-SEK900 million annually, up from SEK716 million in 2019 and SEK750 million in 2020. We expect this to cover capital spending (capex) of about SEK500 million and dividend of about SEK140 million-SEK170 million, leading to further debt reduction to well below SEK2 billion by 2023. As a consequence of increasing cash flows and lower debt, Kraftringen's credit ratios are set to improve further. We now project FFO to debt will increase toward 40% by year-end 2023, from 36% in 2020 and 23% in 2018. This is above our previous expectations and the main reason for the upgrade.

The rating continues to be supported by a high share of stable and predictable cash flows from regulated electricity distribution and stable district heating, despite a challenging year and pressure on DSO regulation. A high share of about 60% of Kraftringen's EBITDA stems from DSO activities. We expect the electricity DSO business to continue to generate stable EBITDA of SEK550 million-SEK650 million annually, with very little volatility. We expect that Kraftringen can maintain stable contribution from its electricity DSO activities, despite the very low weighted average cost of capital (WACC) for the current regulatory period (2020-2023) set at 2.35%, down from 5.85% in the previous period (2016-2019). However, on Feb. 26, 2021, the court ruled in favor of DSOs, stating that the Swedish Energy Market Inspectorate did not adhere to the framework and laws when lowering the WACC to 2.35% over 2020-2023. The court requested the regulator recalibrate the WACC parameters. If the regulator's appeal of the latest verdict is granted, it will likely take until 2022 for the court to announce a final decision. Given this uncertainty, when forecasting for Swedish DSOs in 2021, we continue to assume a WACC of 2.35%, which we understand is the regulator's guidance and would be the worse-case scenario, given that the outcome from the court proceedings cannot result in a lower WACC.

It is now confirmed that DSOs will be allowed to transfer unused revenue from the 2012-2015 and 2016-2019 regulatory periods to the current 2020-2023 and the upcoming 2024-2027 regulatory periods. The unused revenue has arisen because the WACC calculation for both the 2020-2023 and 2024-2027 periods was appealed in court, with a positive outcome for the DSOs. This resulted in late amendments to the WACC, meaning that it was not possible for Kraftringen to increase tariffs to reach the allowed revenue in accordance with its regulated allowed income. We believe that the possibility to collect this revenue during the very low WACC environment gives Kraftringen the possibility to increase its otherwise lower revenue from DSO activities and continue to improve its credit metrics. We understand Kraftringen has about SEK800 million of unused revenue it can collect during the coming years, in addition to its current allowed revenue.

Kraftringen's 100% fossil fuel-free district heating business delivered well, despite the challenging environment. On average, about 35% of EBITDA stems from the district heating segment, which we view as an efficient way to produce heat, with some flexibility to increase or decrease electricity generation when needed. In addition, we view Kraftringen's district heating business as stable with monopoly-like features and high barriers to entry. Pipes are buried in

cities, and it would require extensive work and high costs to challenge the company's position as the heat provider in its region.

The company has managed to achieve fossil fuel-free production much earlier than its peers, as a result of investing in fuel flexibility in its CHP plants. In the district heating business, it uses only renewable fuels, such as biomass (recycled wood). That said, we note that the sustainability concerning bioenergy is an ongoing discussion in the EU Taxonomy.

Kraftringen recorded 90% less carbon emissions in 2020 than in 2007. Kraftringen does not use waste as fuel and was therefore not exposed to the tax on waste as fuel, which was introduced in Sweden in April 2020. The company has also shown resistance to unfavorable electricity and EU Emission Trading System (ETS) prices, thanks to its shift in fuels it uses for its incineration. This will be even more important in 2021, given prices for EU Emission Trading System (ETS) prices have increased significantly already in 2021 with current prices above €50 per ton (/ton), versus the average of about €25/ton in 2020. We therefore expect the higher price not to significantly impact results because the company's need for carbon emissions in terms of EU ETS is lower year on year, as a result of its transformation from fossil fuels for its incineration. Consequently, we expect Kraftringen to have great resilience toward increasing future costs for EU ETS.

Kraftringen's business is also underpinned by the district heating pricing model, under which fixed costs represent about 25% of revenue, which is lower than for peers such as Tekniska verken i Linköping AB (A+/Stable/A-1) and Stockholm Exergi Holding AB (BBB+/Stable/A-2), with fixed prices representing about 45% and 40%, respectively, of revenue.

The utility has a strong link to Municipality of Lund. Kraftringen is a regional multi-utility company, majority owned (82%) by the Municipality of Lund (AAA/Stable/A-1+; 'K-1' Nordic scale rating). We see Lund as a strong and stable shareholder, which has a dominating influence on Kraftringen's strategy and business plans. We understand that there are no political incentives to privatize the company.

Outlook

The stable outlook on Kraftringen reflects our view that the company's fully regulated electricity distribution business and stable district heating operations will likely continue to support cash flow. We expect Kraftringen will maintain S&P Global Ratings-adjusted FFO to debt above 35% in the next couple of years, well above the 30% downgrade threshold for the rating. This positive development is supported by increased operating efficiency and its commitment to deleveraging.

Downside scenario

We could lower our rating if credit measures weakened in contrast to our current forecasts, for example if FFO to debt protractedly stayed below 30%. This could stem from any additional material debt-funded investments or operational underperformance.

Furthermore, considering that the likelihood of extraordinary government support is an important element of our rating on Kraftringen, we could lower the rating if we saw a weakening of assumed support from Lund, due to the municipality significantly diluting its ownership in the company, for example.

Upside scenario

We see the likelihood of a positive rating action as relatively remote, given the company's size, which constrains the business risk profile. Rating upside would therefore likely depend on continued earnings stability and sustainable deleveraging beyond our expectations.

Company Description

Kraftringen is a regional multi-utility company, majority owned (82%) by the Municipality of Lund. The remainder is owned by other municipalities. Most of its contribution to EBITDA stems from regulated activities, mainly DSO but also district heating. It also generates electricity and cooling from its district heating activities. But it is also active in other utility services, such as gas, including natural gas and biogas; fiber network services; and other small scale energy-related services.

In 2020, S&P Global Ratings-adjusted EBITDA amounted to SEK868 million (about €87 million). Its DSO and district heating business account for the vast majority of its total EBITDA. It supplies power to approximately 125,000 connections in Skåne, Blekinge, and Småland.

Energy generation in terms of heat represents about 1,000 gigawatt hours (GWh), and electricity of about 230GWh. Its district heating services provide heat to about 9,000 customers. The company was formerly known as Lunds Energikoncernen AB (publ) and changed its name to Kraftringen Energi AB (publ) in November 2013. It is headquartered in Lund, Sweden.

Our Base-Case Scenario

Assumptions:

- Tariff increases for its district heating business of 1%-1.5% annually.
- WACC of at least 2.35% for its DSO activities for the regulatory period 2020-2023. And use the majority of its unutilized revenue transferred from previous regulatory periods to the current period. The total amount of unused revenue is about SEK800 million.
- EBITDA margin of 23%-25% in 2021-2023.
- Dividend of SEK140 million in 2021, and about SEK160 million-SEK190 million annually in 2022 and 2023.

Key metrics

Kraftringen Energi AB (publ) Key Metrics

	2019a	2020a	2021e	2022e	2023e
EBITDA (mil. SEK)	796	832	800-900	850-950	850-950
FFO (mil. SEK)	716	755	750-850	800-900	800-900
FFO to debt (%)	30.2	36.2	35-40	35-40	38-43

Kraftringen Energi AB (publ) Key Metrics (cont.)

	2019a	2020a	2021e	2022e	2023e
Debt to EBITDA (x)	3.0	2.5	2.5-2.3	2.5-2.3	2.3-2.0

SEK--Swedish krona. FFO--Funds from operations. a--Actual. e--Estimate.

Liquidity

Our assessment of Kraftringen's liquidity position as adequate indicates that, over the next 12 months, available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should be about 1.5x the forecast near-term cash outflows, such as debt repayments, capex, and dividend. We also expect that sources will exceed uses even if EBITDA declines by 10%, and that the company will maintain adequate headroom under its financial covenants (equity to total assets of more than 30%). We also believe that the company has sound relationships with its banks and a satisfactory standing in the credit markets, and that it benefits from its municipal ownership and prudent risk management.

Principal liquidity sources as of March 31, 2021:

- SEK1.3 billion of undrawn bank lines maturing beyond 12 months (consists of two SEK500 million back-up facilities maturing in 2024).
- SEK300 million of revolving credit facility (due in December 2022).
- SEK760 million of cash FFO.

Principal liquidity uses as of the same date:

- SEK500 million of debt maturities (150 million of bonds and SEK350 million of commercial paper).
- SEK600 million of capex.
- SEK140 million of dividend.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/A-2

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/leverage: Modest

Anchor: bbb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile : bbb

- Likelihood of government support: Moderately high (+2 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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: 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

Related Research

- Swedish Electricity DSOs Remain In Limbo As The Regulator Appeals Court Decision On Their Remuneration, March 18, 2021

Ratings List

Upgraded; Ratings Affirmed

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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