

Research Update:

# Ellevio AB Senior Secured And Subordinated Debt Ratings Affirmed At 'BBB' And 'BB+'; Outlook Negative

June 30, 2020

## Rating Action Overview

- Ellevio AB plans to issue subordinated (class B) debt to reduce the outstanding amount of senior secured (class A) debt, which slightly improves rating headroom for the latter.
- As a result, we expect Ellevio's senior secured credit metrics to slightly improve, such that funds from operations (FFO) to debt remains above 6% and debt to EBITDA below 10x, but subordinated metrics (total debt, including subordinated debt) to deteriorate with about 1.1x debt to EBITDA.
- There is also still uncertainty regarding the final outcome of the regulatory reset.
- We are therefore affirming our 'BBB' issue rating on the class A debt and on our 'BB+' issue rating on the class B debt.
- The negative outlook reflects the uncertain situation regarding the Swedish regulatory framework, with ongoing appeals, and limited credit metric headroom.

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## Rating Action Rationale

**We expect stable consolidated debt but an increasing share of class B debt.** Ellevio is the borrower under a ring-fencing structure, with two classes of debt--senior class A debt and subordinated class B debt. Under our methodology, we look at:

- Ellevio's senior debt ratios only to determine the class A debt rating, which is one notch above the senior credit quality (stand-alone credit profile [SACP]) of 'bbb-'.
- Ellevio's consolidated debt ratios only to determine the class B rating, which is rated either two notches below the class A debt or at the same level as the consolidated SACP of 'bb+', whichever is lower.

Historically, the level of class B debt was low at Swedish krona (SEK) 3 billion, and will now

increase to SEK4 billion. The planned transaction will increase the proportion of class B debt to about 10% of total debt, from 7.6% previously, although overall debt remains unchanged. As a result, the ratios underpinning our class A rating are stronger, while the consolidated ratios are weaker. The weaker earnings reflect profitability pressure from the Swedish regulatory update. We have therefore lowered the consolidated SACP to 'bb+' from 'bbb-' on the class B debt, which has no effect on the class B debt rating of 'BB+', since it is already two notches below the 'BBB' class A rating.

**Pending uncertainties regarding the Swedish regulatory framework continue to constrain the rating.**

On June 1, 2020, the regulator updated its weighted-average cost of capital (WACC) calculation in its pronouncement related to ongoing court appeals from distribution system operators (DSOs) in Sweden. The regulator presented a WACC of 2.35%, up from the 2.16% it announced in June 2019 but still below the 5.85% in the previous regulatory period. We understand that the WACC of 2.35% still depends on the Swedish court outcome, but expect a decision from the court of first instance before year end. In our view, Sweden's WACC for DSOs is still among the lowest in Europe. We will monitor the outcome from the appeal court, which we also understand will be announced later this year. We could lower our assessment of the Swedish regulatory framework if, for example, Ellevio was unable to carry forward under-recovered amounts from previous regulatory periods.

**Ellevio will maintain high capital expenditure (capex) in the coming two years and, together with flexible financial policy, maintain credit metrics above our thresholds.**

Ellevio will continue to invest heavily during 2020 and 2021, with investments of SEK3.3 billion-SEK 3.4 billion annually. As a result of these investments, the company's regulatory asset base (RAB) will increase, consequently enabling it to achieve higher regulatory income. We forecast that Ellevio's RAB will increase to about SEK41 billion by 2023 from about SEK31.4 billion in 2019. As a result, we expect to see a decline in revenue of about 8% in 2020, and EBITDA to decrease from about SEK4 billion to SEK3.6 billion in 2020 due to the lower WACC. We also expect Ellevio to take several remedial measures to maintain its credit metrics above our thresholds for a downgrade, including:

- Refraining from paying dividends to its owners;
- Carrying forward unutilized revenue from the two previous regulatory periods; and
- Borrowing up to 5% of the coming 2023-2027 regulatory period's revenue cap to cover lower revenue over the 2020-2023 period.

We therefore believe Ellevio will be committed to maintaining FFO to debt above 6%, and debt to EBITDA below 10x, which we find commensurate with the current class A debt rating. We forecast that Ellevio can keep class A FFO to debt at 6.5%-7.5% in 2020-2022, compared with 7.6% in 2019. This is despite challenging conditions, with significantly lower WACC for the 2020-2023 regulatory period. Nevertheless, we expect class A debt to EBITDA to be very close to our threshold of 10.0x.

**We do not expect any forms of shareholder distributions during the current regulatory period.**

The absence of planned interest payments for its shareholder loans results in total loans of SEK26 billion by year-end 2023, compared with SEK20.7 billion in 2019, as interest is added to debt. We view negatively the significant portion of shareholder funds in the capital structure, which are in the form of shareholder loans. However, we exclude the loans from debt in our ratio calculations, reflecting their equity-like features such as subordination, maturities beyond all other debt, and the possibility of accruing interest.

## Outlook

The negative outlook indicates that we could lower our ratings on Ellevio's senior secured debt (class A) and its subordinated debt (class B) if its financial metrics deteriorate because of the lower revenue in the current regulatory period. A material acquisition or shareholder returns could also pressure the rating.

We also expect Ellevio to maintain debt to EBITDA below 12x for its total debt, including subordinated debt.

## Downside scenario

We could lower the rating by more than one notch if we re-assess the Swedish regulatory framework as less than strong. For example, if Ellevio was unable to carry forward under-recovered amounts from previous regulatory periods

We also could lower the ratings if Ellevio was unable to exercise significant flexibility in its financial policy, for example, by lowering shareholder distributions or capex, and this resulted in FFO to debt below 6%, or debt to EBITDA above 10x for the senior debt.

We could lower the subordinated debt rating if we lower the senior debt rating or if debt to EBITDA rises above 12x at the consolidated level, including subordinated debt.

## Upside scenario

We could revise the outlook to stable if uncertainties surrounding the regulatory framework for the current period are resolved, for example, when the pending court appeals are settled.

We could also revise the outlook to stable if Ellevio shows exceptional flexibility in its financial policy, resulting in FFO to debt of at least 6%, and debt to EBITDA below 10x with comfortable headroom under our senior secured and subordinated rating thresholds.

## Company Description

Together with Vattenfall and E.ON, Ellevio is one of the three largest electricity DSOs in Sweden. Ellevio's market share, in terms of customers, is about 17.5%. It has about 962,000 customers, and operates in four Swedish regional areas, with the majority of its customers in the Stockholm area. As well as delivering electricity, Ellevio is responsible for maintaining and developing its network.

The Government and Energy Markets Inspectorate regulates all of Ellevio's operations, primarily through the Swedish Electricity Act, and by different ordinances. In 2019, the company reported sales of almost SEK7 billion and EBITDA of SEK4 billion (€400 million equivalent).

Ellevio is owned by Omers Infrastructure Holdings (formerly Borealis Infrastructure Management; with a 50% share); two of the Swedish states' buffer funds within the national pension system AP3 (20%) and AP1 (12.5%); and Folksam (17.5%), which acquired Ellevio from Fortum Oyj for about SEK61 billion in June 2015.

## Our Base-Case Scenario

### Assumptions

- Sweden's GDP will decline 6.4% in 2020, then increase by 4.8% in 2021 and 2.9% in 2022.
- WACC of at least 2.35%, resulting in about 2% lower revenue in 2020 versus 2019, despite a higher RAB.
- EBITDA margins of about 53%-55% for the current regulatory period.
- DSO's can carry forward under-recovered funds from previous periods.
- Up to 5% is borrowed from the upcoming 2023-2027 regulatory period's revenue cap to cover lower revenue over 2020-2023.
- Capex of SEK3.3 billion-SEK3.4 billion in 2020 and 2021. We then expect capex to decline toward SEK2.7 billion-SEK2.9 billion in 2022.
- Subordinated debt will not exceed 10% of total debt.
- No shareholder distributions in 2020-2022.

### Key metrics

#### Ellevio AB (publ)

(MIL. SEK)	--Fiscal year ended Dec. 31--				
	2018a	2019a	2020e	2021f	2022f
Revenues	7,058	6,810	6,200-6,300	6,500-6,600	6,400-6,500
EBITDA	4,321	3,986	3,400-3,600	3,500-3,700	3,500-3,700
RAB	24,900	31,400	36,500	40,000	41,000
Class A--FFO to debt (%)	7.1	7.6	6.5-7.5	6.5-7.5	6.5-7.5
Class A--Debt to EBITDA (x)	8.3	9.1	9.5-9.9	9.5-9.9	9.5-9.9
Total debt--FFO to debt (%)	6.5	7	6.0-6.5	6.0-6.5	6.0-6.5
Total debt--Debt to EBITDA (x)	9	9.8	10.5-11.0	10.5-11.0	10.5-11.0

\*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. RAB—Regulatory asset base. FFO—Funds from operations. SEK—Swedish krona.

### Liquidity

We view Ellevio's liquidity as strong and expect it to remain strong. We believe that available liquidity sources should exceed forecast near-term cash outflows by 2.0x. In our assessment of liquidity, we also factor in qualitative factors, such as the company'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 Ellevio will maintain adequate headroom under its financial covenants.

Principal liquidity sources as of March 31, 2020, include:

- Forecast FFO of about SEK2,500 million.
- Available cash and marketable securities of about SEK20 million.
- Access to committed credit lines of about SEK3,500 million.
- Green bond issuance totaling SEK1,650 million in June 2020.
- Working capital inflows of about SEK330 million.

Principal liquidity uses, for the same period, include:

- Capex of about SEK3,300 million over the next 12 months.
- Debt repayment of SEK600 million in the coming 12 months.

## **Covenants**

The credit facility contains covenants for lock-up of 10.75x, and for default, stipulating debt to EBITDA of 12.00x and interest coverage of 1.7x and 1.2x for senior debt. It also contains lock-up and default covenants for total debt, with debt to EBITDA at 11.9x and 13x respectively.

Ellevio complies with the debt-maturity limitations in the documentation, and has met all of its financial covenants in the past.

## **Issue Ratings - Subordination Risk Analysis**

### **Capital structure**

Ellevio is the operating company in the Ellevio group, which comprises four holding companies. The ultimate owners are international investor OMERS Infrastructure; 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.

Ellevio issues two types of debt, senior (class A) and subordinated (class B). We analyze the group in two steps because we assess the subordinated debt as having a greater risk of default than the senior debt. This is because the subordinated debt would be paid after the senior debt, and has no claim on the security until the senior debt is paid, and its default could not cause the senior debt to default.

- Class A debt is rated 'BBB' based on credit metrics excluding the subordinated debt, and including one notch of uplift for various structural features, in particular the additional protection from the deferral of the subordinated debt interest and principal if the financing group had insufficient cash to make the payments due.
- Class B debt is rated 'BB+' based on credit metrics including senior and subordinated debt.

We rate Ellevio's senior secured debt one notch higher than the 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.

## **Ratings Score Snapshot**

### **Class A Issue Rating: BBB/Negative**

Business risk: Excellent

- Country risk: Very Low
- Industry risk: Very Low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive (low volatility table)

Anchor: bbb

Modifiers

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

Stand-alone credit profile: bbb-

- Structural enhanced debt: +1 notch

### **Class B Issue Rating: BB+/Negative**

Business risk: Excellent

- Country risk: Very Low
- Industry risk: Very Low

- Competitive position: Strong

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged (low volatility table)

Anchor: bbb-

Modifiers

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

Stand-alone credit profile: bb+

## **Related Criteria**

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 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 | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, 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

## Related Research

- Credit FAQ: Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs?, Aug. 21, 2019.
- Outlook On Ellevio's Senior Secured And Subordinated Debt Revised To Negative; 'BBB' And 'BB+' Ratings Affirmed, July 2019.

## Ratings List

### Ratings Affirmed

#### Ellevio AB

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Senior Secured	BBB/Negative
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Subordinated	BB+/Negative
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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](http://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](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](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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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