

Research Update:

# Outlook On Ellevio's Senior Secured And Subordinated Debt Revised To Negative; 'BBB' And 'BB+' Ratings Affirmed

July 5, 2019

## Rating Action Overview

- On June 24, Sweden's regulator for electricity distribution operators (DSOs) announced the weighted average cost of capital (WACC) for the new 2020-2023 regulatory period will be 2.16%, versus 5.85% in the current regulatory period and 3.0% expected for Ellevio.
- We expect the reduced WACC will adversely affect Ellevio's revenue and credit metrics, pushing funds from operations (FFO) to debt to about 6% in 2020-2023, which is our threshold for the rating.
- We are therefore revising our outlooks to negative from stable on our 'BBB' rating on the senior secured (class A) debt and on our 'BB+' rating on the subordinated (class B) debt, and affirming both ratings.
- The negative outlook reflects the risk of a downgrade within the next two years if Ellevio cannot maintain its financial position, namely with FFO to debt sustainably above 6%, and debt to EBITDA below 10x, likely due to pressure from the regulatory environment.

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## Rating Action Rationale

The outlook is negative because we expect that Ellevio will be operating with limited headroom under our threshold for the current ratings, owing to the regulator's (Energimarknadsinspektionen) lower WACC for the upcoming 2020-2023 regulatory period than Ellevio and we had expected.

On June 24, 2019, the regulator announced its decision for WACC at 2.16% for the next regulatory period. This is materially lower than the 5.85% WACC for the current regulatory period and Ellevio's initial expectations for 3% WACC. The lower WACC will likely result in lower revenue for Ellevio than we expected.

Furthermore, lower revenue will most likely result in deteriorating credit metrics, with the risk that FFO to debt will be below 6% for both the class A and class B debt, and that debt to EBITDA will be

above 10x after 2020 for both the class A and class B debt. However, although these projected metrics could translate to a lower rating, a downgrade would hinge on the regulator's final revenue frames.

We note that the European Commission sent a letter to the Swedish government on May 22, 2019, notably referring to the detailed parameters in the WACC calculation and the right to appeal to an independent body. Moreover, an answer from the Swedish government is expected by the end of July. At this point, therefore, the final allowed revenue framework for Ellevio is still uncertain (hence also Ellevio's projected revenue). The final allowed revenue framework for the 2020-2023 period must be communicated before Oct. 31, 2019.

We also expect Ellevio to take several remedial measures to maintain its credit metrics above our thresholds for a downgrade:

- Refrain from paying dividend to its owners;
- Possibly carry forward unutilized revenue from the two previous regulatory periods; and
- Borrow from the next coming regulatory period's revenue cap 2023-2027 to cover lower revenue over the 2020-2023 period.

In our view, Ellevio has an ambitious capital expenditure (capex) plan, with the flexibility to scale down investments if needed.

Additionally, our current strong assessment of the Swedish regulatory framework reflects our view of the framework as predictable and stable, with an independent regulator and tariff-setting process. In our opinion, politicians' recent involvement in setting the level of remuneration by issuing decrees could result in our re-assessment of the Swedish regulatory framework. This would occur especially if we believed that the framework did not allow Swedish power distribution companies to recover their operating costs in full. Such a change could result in a downward adjustment of the ratings by more than one notch.

## **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) over the next 12-24 months if Ellevio's financial metrics deteriorate because of lower revenue frames and if Ellevio and its owners do not implement significant remedial measures should Energimarknadsinspektionen's current WACC level be confirmed.

## **Downside scenario**

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

## **Upside scenario**

We could revise the outlook to stable if Ellevio shows exceptional flexibility in its financial policy,

with much lower capex than expected, resulting in FFO to debt of at least 6%, and debt to EBITDA below 10x, our thresholds for the current ratings.

We could also revise the outlook to stable if the regulatory framework for the upcoming period is amended, with a higher WACC, for example following the revocation of the recent political decree.

## **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 18%. It has about 957,000 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 2018, the company reported sales of SEK7 billion and EBITDA of SEK4.3 billion (€420 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 SEK60.6 billion (€6.6 billion) in June 2015.

## **Our Base-Case Scenario**

- Stable contribution from its DSO activities, supporting EBITDA generation of about Swedish krona (SEK) 4.3 billion in 2019 and SEK3.5 billion in 2020.
- WACC at 2.16%, resulting in about 10% lower revenue in 2020 versus 2019.
- DSO's ability to carry forward under-recovered funds from previous periods.
- Borrow from the upcoming regulatory period's revenue cap 2023-2027 to cover lower revenue over the 2020-2023 period.
- EBITDA margins expected at 62%-64% for 2019, and at about 56%-58% for the upcoming regulatory period.
- Capex of around SEK4 billion in 2019, and about SEK3 billion annually in the following two years.
- No shareholder distributions in 2019-2021.

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

- FFO to debt of about 8% in 2019, and at about 6%-6.5% in 2020-2021.
- Debt to EBITDA of 8.5x in 2019, and about 10.5x in 2020- 2021.

## **Liquidity**

Ellevio has strong liquidity, in our view. Available liquidity sources should be well in excess of 1.5x liquidity uses over the near term and above 1.0x over the coming 24 months. We also assume that liquidity sources will exceed uses even if EBITDA were to decrease by 30%.

According to our calculations, Ellevio's liquidity sources as of March 31, 2019, comprise:

- Available cash and marketable securities of about SEK31 million.
- Access to committed credit lines of about SEK8.9 billion.
- Forecast FFO of about SEK 4.5 billion.

Expected liquidity uses as of the same date include:

- Capex of about SEK3.4 billion per year.
- Debt maturities of SEK3.5 billion in the next 12 months.
- No dividends.

## **Covenants**

The credit facility contains covenants for lock-up of 10.75x, and for default stipulating debt to EBITDA of 12.00x and interest cover of 1.7x and 1.2x. 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**

### **Structural Enhancements**

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. We rate Ellevio's senior secured debt one notch higher than Ellevio's stand-alone credit profile (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**

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Senior Secured Debt (Class A) Rating: BBB/Negative/--

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Subordinated Debt (Class B) Rating: BB+/Negative/--

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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)
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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 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
- 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
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

	To	From
<b>Outlook Action; Ratings Affirmed</b>		
<b>Ellevio AB</b>		
Senior Secured	BBB/Negative	BBB/Stable
Subordinated	BB+/Negative	BB+/Stable
Senior Secured Medium Term Notes	BBB	
Subordinated Medium Term Notes	BB+	

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