Research Update:

Kraftringen Energi AB (publ) 'A-/A-2' Ratings Affirmed; Outlook Stable

May 21, 2024

PRIMARY CREDIT ANALYST

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

SECONDARY CONTACTS

Maria Hjukstrom
Stockholm
maria.hjukstrom@spglobal.com

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

Rating Action Overview

- Swedish utility company Kraftringen Energi AB (publ) (Kraftringen) reached an agreement to divest assets related to its unregulated hydro power generation and service operations. We expect this will strengthen Kraftringen's business risk profile as almost all remaining activities, such as district heating and energy distribution, are regulated.
- At the same time, it is likely that Kraftringen will double its investments to about Swedish krona (SEK) 1.3 billion-SEK1.5 billion over 2024-2026, from about SEK640 million-SEK660 million over 2022-2023, to renew its district heating capacity.
- Due to increased investments, however, we expect funds from operations (FFO) to debt will decrease to 24%-28%, despite the disposals, over the next two to three years and therefore lowered our financial risk profile assessment to intermediate from modest. S&P Global Ratings-adjusted debt stood at about SEK2.4 billion as of year-end 2023.
- Since the worsening financial risk profile offsets the strengthening business risk profile, we affirmed our 'A-/A-2' long- and short-term issuer credit ratings on Kraftringen.
- The stable outlook indicates our expectation that the company will maintain adjusted FFO to debt above 23%.

Rating Action Rationale

We think Kraftringen's business risk profile will improve after the divestment of its unregulated business segments. Kraftringen will focus its business strategy on regulated electricity distribution and district heating operations, which will account for almost 100% of EBITDA after the contracted divestment of the company's Norwegian hydro assets. We therefore raised our business risk profile assessment to strong from satisfactory. Kraftringen's electricity distribution segment is the fifth-largest in Sweden and we expect it will contribute to about 65% of the company's EBITDA. Over the new regulatory period (2024-2027), Kraftringen will benefit from a higher weighted average cost of capital (WACC), which is proposed at 4.53%.

In the past two years, Kraftringen's EBITDA and debt suffered from the Norwegian production units the company is now disposing. The Norwegian hydro assets resulted in significant margin calls on Kraftringen's hedged positions in 2022, when power prices in various price zones unexpectedly diverged. The company is now planning to dispose these assets, along with its subsidiary Kraftringen Service AB (KSAB), which provides contracting and maintenance services related to power utilities. KSAB struggled with negative results in the past two years. Both deals will likely close in the second quarter of 2024. We expect Kraftringen's cash flows will become more stable and predictable after the transactions.

We expect investments will double over 2024-2026 if Kraftringen renews its heat and power (CHP) plants. If it materializes, the renewal of Kraftringen's CHP plant that is currently in the planning stage will more than double capital expenditure (capex) to about SEK1.4 billion-SEK1.5 billion over 2025-2026, compared with about SEK660 million in 2023. Despite the expected proceeds from the divestments in 2024, this will lead to significantly weaker credit ratios than we expected. FFO to debt will likely approach 25%, compared with our previous forecast of about 40%-45%. We think it is highly likely that management will invest in the CHP plant renewal and therefore revised Kraftringen's financial risk profile to intermediate from modest. We assess the company's financial measures by using our medial-volatility financial benchmark table due to its share of lower-risk regulated electricity distribution and district heating operations.

Kraftringen received approval from the Land and Environment Court in April 2024 to continue the development to renewew its district heating plant in Örtofta. We understand that management has some flexibility on the project size and that the size could be adjusted if rating headroom tightens because of changing market conditions. Nevertheless, the investment will likely be sizable and increase capex to about SEK1.5 billion in 2025. We view the technology risk for the project as low as Kraftringen already operates similar plants and is well aware of the technology.

Kraftringen's operating performance recovered in 2023 and we expect this trend will continue in 2024, with EBITDA of about SEK820 million-SEK850 million, compared with SEK783 billion in 2023. We expect adjusted EBITDA of SEK1 billion annually over the coming three years and forecast debt will exceed SEK3.7 billion in 2026, from SEK2.4 billion in 2023. After reporting extraordinarily weak results of SEK540 million in 2022, mostly due to a one-off close of the hedging position for the Norwegian power production and the loss-making service operations, Kraftringen recorded adjusted EBITDA of about SEK780 million in 2023. However, this still fell short of our previous expectation of SEK800 million-SEK900 million as rising biofuel costs and mild weather affected district heating operations, while lower-than-expected power and gas prices depressed revenues from other operating segments. The company also suffered from an increase in interest expenses to about SEK130 million in 2023, from SEK65 million in 2022. We expect interest costs will remain high as leverage increases.

Kraftringen has a strong link to the Municipality of Lund (AAA/Stable/A-1+). The Municipality of Lund owns 82% of Kraftringen. We see Lund as a strong and stable shareholder with a dominating influence on Kraftringen's strategy and business plans. We understand that political incentives to privatize the company do not exist. This results in a two-notch uplift to the rating on Kraftringen as we continue to see a moderately high likelihood of extraordinary government support for Kraftringen. This is based on the company's strong link to the government, which is primarily reflected by Kraftringen's 100% ownership by Kraftringen AB (not rated), a holding company that is owned by the municipalities of Lund (82%), Eslov (12%; not rated), Hörby (4%; not rated), and Lomma (2%; not rated). Kraftringen's operations are strongly aligned with the interests of the four municipalities, particularly Lund, which has a strong affiliation with, and controlling influence over, the company. Kraftringen is important to Lund since it provides critical public services and contributes to Lund's environmental agenda.

Outlook

The stable outlook reflects our view that Kraftringen's regulated activities, including its electricity distribution business and stable district heating operations, will likely continue to support cash flows and account for most of the company's EBITDA.

We expect Kraftringen will increase its investments over 2024-2025, which will weaken adjusted FFO to debt. Yet we expect FFO to debt will remain at 23%-30% over the next two years. This is supported by the sale of some assets that will support the balance sheet.

Downside scenario

We could lower our ratings if:

- Kraftringen's credit metrics weakened materially against our forecasts, for example if FFO to debt sustainably remained below 23%. This could stem from additional material debt-funded investments, operational underperformance, or capex over-run; or
- Assumed support from Lund--whose likelihood of extraordinary government support is an important element of our rating on Kraftringen--weakened due to the municipality significantly reducing its stake in the company. At the current 'AAA' rating level, a one-notch downgrade of Lund would not immediately trigger a downgrade of Kraftringen.

Upside scenario

Because of Kraftringen's small size, we see a further strengthening of the business risk profile as unlikely. Any ratings upside would therefore most likely stem from continued earnings stability and sustainable deleveraging beyond our expectations, with FFO to debt remaining sustainably above 30%. We could also take a positive rating action on Kraftringen if its relationship with Lund strengthened.

Company Description

Kraftringen is a Swedish multi-utility company that is majority-owned by the Municipality of Lund, where the company is headquartered. The company generates, distributes, and sells electricity. It also provides district heating and cooling services, photovoltaic services, gas--including natural gas and biogas--fiber optic network services--such as black fibre, internet, and telephony services--and energy-related services. In 2023, the company's adjusted EBITDA amounted to SEK783 million. Its electricity distribution and district heating business account for the vast majority of total EBITDA.

Kraftringen supplies power to approximately 125,000 connections in Skåne, Blekinge, and Småland. Its district heating services provide heat to about 9,000 customers.

Our Base-Case Scenario

Assumptions

- Distribution system operator (DSO) activities to represent 60%-65% or SEK700 million-SEK800 million of the company's total EBITDA after the disposals.
- WACC for DSO activities of 4.53% for the regulatory period over 2024-2027. WACC for the previous period over 2020-2023 is still not finalized but is assumed to be at least 2.35%.
- Capex of about SEK880 million in 2024 and SEK1.4 billion-SEK1.5 billion over 2025-2026 due to investments in the CHP plant expansion.
- Annual dividends of about SEK100 million over 2024-2026.

Key metrics

Kraftringen Energi AB (publ)--Forecast summary

(Mil. SEK)	2022a	2023a	2024e	2025f	2026f
EBITDA	540	783	800-900	1,000-1,100	1,100-1,200
Funds from operations (FFO)	414	661	600-700	800-900	850-950
Debt	2,517	2,441	2,300-2,600	2,900-3,200	3,600-3,900
Adjusted ratios					
Debt/EBITDA (x)	4.7	3.1	2.6-3.3	2.6-3.2	3.0-3.5
FFO/debt (%)	16.4	27.1	23.0-27.0	25.0-31.0	23.0-27.0

All figures adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. SEK--Swedish krona.

Liquidity

We view Kraftringen's liquidity position as adequate. We expect that, over the next 12 months, available liquidity sources in terms of cash, committed credit facilities, and operating cash flow, will exceed near-term cash outflows, such as debt repayments, capex, and dividends, by 2.3x. We also expect liqudity sources will exceed uses even if EBITDA declines by 50%. The company has demonstrated in the past that it does not intend to have a liquidity-sources-to-uses ratio that exceeds 1.5x, especially because of the short-term facilities it uses during regulatory periods. Kraftringen is not active on the international bond market but relies on local markets for funding.

Kraftringen's liquidity sources for the 12 months from March 31, 2024, comprise:

- Cash of about SEK1.01 billion; and
- SEK1.5 billion in undrawn bank lines that will mature after 12 months.

Principal liquidity uses over the same period include:

- No debt maturities over the next 12 months and SEK950 million over the subsequent 12 months;

- Capex of SEK995 million; and
- Dividends of about SEK110 million.

Covenants

We estimate Kraftringen's headroom toward its covenants is adequate. The covenant requires a ratio of equity to total assets of more than 30%. This ratio stood at about 44% at year-end 2023.

Environmental, Social, And Governance

Environmental factors are a moderately negative consideration in our credit rating analysis of Kraftringen because of the carbon footprint from the company's district heating activities, which account for about 35% of EBITDA. Kraftringen aims to offset this by managing its district heating operations on a fossil fuel-free basis. Governance factors are also a moderately negative consideration, mainly due to Kraftringen's limited scope and the relatively small size of the company. Management's decision to hedge the Norwegian hydro power production via the Nord Pool system price led to material financial losses in 2022. However, we view the steps taken thereafter to mitigate future negative exposure as evidence of a prudent risk management that offsets the previous governance shortcomings.

Ratings Score Snapshot

Issuer credit rating	**A-/Stable/A-2**
Business risk:	Strong
Country risk	Very low
Industry risk	Very low
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
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	Neutral (no impact)
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile:	bbb
Related government rating	AAA
Likelihood of government support	Moderately high (+2 notches)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- 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

- Nordics Utilities Outlook 2024: Increasing Volatility Fuels Uncertainty, Feb. 15, 2024
- Municipality of Lund, Sept. 25, 2023

Ratings List

Ratings Affirmed	
Kraftringen Energi AB (publ)	
Issuer Credit Rating	A-/Stable/A-2
Nordic Regional Scale	--/--/K-1
Commercial Paper	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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.