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## Research Update:

# Swedish Multi-Utility Kraftringen Energi AB Affirmed At 'BBB+' With Stable Outlook After Refinancing; Off Watch

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## Research Update:

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## Rating Action Overview

- Kraftringen has issued two bonds for a total amount of Swedish krona (SEK)500 million, and extended the maturity of its SEK500 million backup facility by five years, following its acquisition of a controlling stake in Skånska Energi in November 2018, which it initially funded with short-term debt.
- We now expect that Kraftringen's liquidity sources will cover liquidity uses by more than 1.1x over the coming year, even if EBITDA declines by 10%.
- We are affirming our 'BBB+' and 'K-1' ratings on Kraftringen and removing them from CreditWatch negative.
- The stable outlook reflects our expectation that although Kraftringen's metrics will weaken following the acquisition, its ratio of funds from operations (FFO) to debt will exceed 23% in 2018-2020, which is our threshold for the rating.

## Rating Action Rationale

The rating affirmation reflects Kraftringen's improved liquidity situation and our expectations that the company's FFO to debt will be above 23%. Kraftringen Energi successfully issued two bonds in December for a total amount of SEK500 million. It also renewed one of its SEK500 million backup facilities for another five years, now maturing in 2024.

We had placed the ratings on Kraftringen on CreditWatch negative in November 2018, after the company has increased its stake in Skånska Energi to 63% from 10% for SEK323 million (€31.3 million), funded with short-term debt, which triggered our concerns about liquidity.

After the refinancing, we view Kraftringen's liquidity as adequate, with long-term liquidity sources covering liquidity needs for the next 12 months by over 1.1x.

Our belief is that 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 to 23%-25% in the next two years, and potentially above 26% going forward, from about 32% in 2017.

We believe the upcoming regulatory period (2020-2023) for electricity distribution system operators (DSOs) will not materially affect Kraftringen, even though a decrease in weighted-average cost of capital (WACC) is expected. This is because a recent court ruling in Sweden allows DSOs to carry under-recovered revenues from the first regulatory period through to the third. This is positive for Kraftringen because it has a large surplus that it can now carry forward. It has not increased prices as much as some other DSOs in Sweden.

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, if the remaining minority shareholders are not willing to divest, this 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 addition, we expect a smooth integration of Skånska Energi, and do not expect significant costs related to the integration.

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.

## **Outlook**

The stable outlook on Kraftringen reflects our expectation of a smooth integration of Skånska Energi, and our belief that Kraftringen will continue to benefit from its regulated and stable electricity distribution operations and fairly steady district heating operations. We estimate FFO to debt deteriorated to about 23%-25% in 2018 because of the Skanska Energi acquisition, but we expect it to rise above 26% from 2020.

### **Downside scenario**

We could lower our ratings on Kraftringen Energi if credit ratings weakened materially in contrast to our forecasts, for example if FFO to debt protractedly stayed below 23%. This could stem from problems in integrating Skanska Energi, additional material debt-funded investments, or operational underperformance. We could also lower the rating if Kraftringen Energi's liquidity deteriorated below our thresholds for an adequate liquidity assessment.

Furthermore, given that the likelihood of extraordinary government support is an important element of our ratings on Kraftringen Energi, we could lower the ratings if we saw a weakening of assumed support from Lund, due to the municipality significantly diluting its ownership in the company. However, we view this as unlikely at present.

## **Upside scenario**

We could consider an upgrade if Kraftringen's FFO to debt rose sustainably above 30% and its free operating cash flow was positive. We do not expect this to occur in the next two to three years because of the recent debt-funded acquisition.

## **Company Description**

Kraftringen is a regional multi-utility company, majority-owned (82%) by the municipality of Lund. It has several business activities with about 260,000 customers in total, but electricity distribution and district heating account for about 85% of EBITDA.

## **Our Base-Case Scenario**

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

- Relatively stable electricity and heating production and fuel costs, supporting EBITDA generation of roughly SEK780 million in 2019. In 2020, we expect EBITDA to increase to about SEK850 million.
- Capital expenditure of around SEK500 million annually over the coming two years.
- Acquisition costs of SEK323 million for 53% of shares in Skånska Energi.
- Shareholder distributions of about SEK100 million per year.
- 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 of 3x4x in 2019 and 2020.

## **Liquidity**

We estimate that after the refinancing and reduction of the 2019 capital expenditure budget, Kraftringen's sources of liquidity for 2019 include SEK96 million in cash balances, SEK1,300 million of committed long-term bank lines (two SEK500 million long-term bank facilities, one maturing in January 2020 and the other in 2024), a SEK300 million revolving credit facility maturing in 2021, and expected FFO of about SEK550 million annually. Key uses of liquidity include sizable SEK1,100 million short-term debt maturities, capital expenditure of about SEK480 million, and about SEK100 million annual dividends.

## **Ratings Score Snapshot**

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

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: 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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Negative (-1 notch)

Stand-alone credit profile: bbb-

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

## **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 | General: Corporate Methodology: Ratios And

Adjustments, 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: 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+/Stable/A-2	BBB+/Watch Neg/A-2
Nordic Regional Scale	K-1	K-1/Watch Neg
Senior Unsecured	BBB+	BBB+/Watch Neg
Commercial Paper	K-1	K-1/Watch Neg

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