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Research Update:

Multi-Utility Kraftringen Energi Outlook Revised To Positive On Improved Financial Position; Affirmed At 'BBB+/A-2'

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Overview

- Sweden-based Kraftringen Energi has continued to generate solid cash flows and to deleverage following the completion of the combined heat and power plant in Ortofta; and we understand that the company has used the proceeds from its recent divestment of its non-core electricity network in Nynäshamn to further repay debt.
- Kraftringen Energi's improved financial position has led to a material strengthening of its credit ratios that exceeds our expectations for the current ratings.
- We are therefore revising our outlook on Kraftringen Energi to positive from stable and affirming our 'BBB+/A-2' and 'K-1' ratings.
- The positive outlook reflects the possibility of an upgrade within the next two years if Kraftringen Energi were to sustain its improved financial position by continuing to generate positive free operating cash flows and maintain a funds from operations-to-debt ratio at about 28%-30%.

Rating Action

On Feb. 22, 2017, S&P Global Ratings revised its outlook on Swedish regional multi-utility Kraftringen Energi AB to positive from stable. At the same time, we affirmed our 'BBB+/A-2' long- and short-term corporate credit ratings and our 'K-1' short-term Nordic regional scale rating.

Rationale

The outlook revision follows Kraftringen Energi's successful debt reduction since the completion of the new combined heat and power (CHP) plant in Ortofta in the first half of 2014. The new CHP plant provides a more cost efficient production, and its performance has supported the company's cash flow generation. Furthermore, Kraftringen Energi disposed its non-core distribution network in Nynäshamn in December 2016, and we understand that the proceeds were used for further debt reduction. According to our estimates, Kraftringen Energi's debt at year-end 2016 is about Swedish krona (SEK) 450 million less than its debt at year-end 2015. This, together with continued solid cash flow generation, in our view, will lead to a material improvement in credit ratios. We now expect funds from operations (FFO) to debt of about 29% in 2016 versus about 24% in 2015. Although we can see such metrics translating into a higher rating, an upgrade would hinge on the improvement in financial position being sustainable.

We assume that operating cash flows will be reasonably stable over the next few years, and that Kraftringen Energi will generate positive free operating cash flow despite its ongoing, and relatively sizable, investments to weather proof the network and in fiber extensions.

The regulatory allowed return for the electricity distribution of 4.53% for 2016-2019 is lower than the 6.30% for the previous period. This has been appealed by several distribution service operators, and we note that the outcome of the previous dispute related to the 2012-2015 revenue caps favored the operators. A higher allowed return would, if used by the company, support additional improvements of credit ratios.

In our opinion, Kraftringen Energi's business risk profile primarily reflects its operations in the very low-risk regulated electricity distribution and stable district heating businesses, which make up approximately 70% of its EBITDA. The company's competitive position is supported by our view of the regulatory framework for electricity distribution in Sweden as stable and predictable, despite, as mentioned above, periodical disputes between the regulator and distribution service operators related to the level of regulatory allowed return.

However, we think that Kraftringen Energi's limited scale and diversity continues to constrain its competitive position. The electricity distribution grid covers a relatively small area, which makes the company more vulnerable to extraordinary weather conditions. The company's district heating and electricity production businesses are also reliant on a few key assets, exposing it to any operational difficulties. We also note that, although Kraftringen Energi operates as a natural monopoly in the local district heating market, there is no defined regulatory framework that would guarantee cost cover to offset volatility that can arise from fluctuations in heating volumes and fuel prices, due, for example, to warmer temperatures during winter. Continued low electricity prices can also increase competition from alternative heating sources, such as heating pumps.

Under our base case for 2016-2018, we assume:

- Relatively stable electricity and heating production and fuel cost to support EBITDA generation of about SEK640 million in 2016, improving slightly to SEK640 million-SEK660 million in 2017, primarily reflecting relatively mild weather in 2016.
- Annual capital expenditures of about SEK410 million in 2016, rising to about SEK550 million in 2017 following bigger investments in weather proofing and fiber.
- Moderate shareholder distribution policy, with a minimum yearly dividend of SEK60 million

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

- FFO to debt of about 29% in 2016 and 27%-29% in 2017-2018.
- FFO cash interest coverage of 11.5x in 2016 and 9x-11x in 2017-2018.

We continue to incorporate into our long-term rating on Kraftringen Energi a two-notch uplift to reflect our view of a moderately high likelihood of extraordinary support for Kraftringen Energi from the Municipality of Lund in case of financial stress at the company. This is based on our assessment of Kraftringen Energi's:

- Strong link to the municipality, primarily reflecting Lund's 82% ownership of the company through the holding company Kraftringen AB, in which the remaining shareholders are the municipalities of Eslöv (12%), Hörby (4%), and Lomma (2%). Kraftringen Energi's operations are strongly aligned with the interests of the four municipalities and, in particular, Lund, which has a strong affiliation with, and controlling influence over, the company; and
- Important role for Lund, given its focus on providing critical public services and contributing to Lund's environmental agenda.

Liquidity

The short-term rating is 'A-2'. We view Kraftringen Energi's liquidity position as adequate. We believe that, over the next 12 months, available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should be more than 1.1x forecast near-term cash outflows such as debt repayments, capital expenditures, and dividends. 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 covenant, which is 30% equity to assets.

In addition, we believe that the company has sound relationships with its banks, a satisfactory standing in the credit markets (as evidenced by recent refinancing of 2018 bond), and prudent risk management.

Principal liquidity sources:

- SEK67 million in cash and cash equivalents as of Dec. 31, 2016;
- Access to SEK1 billion through two SEK500 million committed credit lines maturing in 2019-2020, used as back-up financing for a SEK1 billion commercial paper program;
- Access to a total of SEK300 million through revolving credit facilities with a Nordic bank, maturing in 2021;
- Access to SEK72 million under a credit facility with Lund of SEK120 million maturing in 2019; and
- Forecast FFO of at least SEK500 million annually.

We also note that in February 2017, the company refinanced a SEK 475 million bond maturing in February 2018.

Principal liquidity uses:

- At least SEK60 million of forecast annual dividends;

- About SEK550 million of forecast capital expenditures in 2017; and
- Debt maturities of SEK882 million, of which SEK510 million relate to commercial paper, in the 12 months from Dec. 31, 2016.

Outlook

The positive outlook on Kraftringen Energi reflects its strengthened financial position and improvement in credit measures. If sustained, these improvements could lead us to upgrade Kraftringen Energi within the next two years. In addition, the positive outlook also incorporates our expectation that the company will continue to benefit from its regulated and stable electricity distribution operations and fairly steady district heating operations. We also take into account our expectation that the company will continue to generate positive free operating cash flows, supported by the new CHP plant in Ortofta.

Upside scenario

We could consider an upgrade if Kraftringen Energi were to sustain its improved financial position. This incorporates the company's ability to continue to generate positive free operating cash flows and, all else equal, if it sustained FFO to debt at about 28%-30%.

Downside scenario

We could revise the outlook to stable if credit measures weakened in contrast to our current forecasts, for example if FFO to debt protractedly stayed below 28%. 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 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, for example.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Positive/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

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- 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: National And Regional Scale Credit Ratings, Sept. 22, 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 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. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Outlook Action; Ratings Affirmed

	To	From

Kraftringen Energi AB (publ)		
Corporate Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
Nordic Regional Scale	--/--/K-1	--/--/K-1

Ratings Affirmed

Kraftringen Energi AB (publ)	
Senior Unsecured	BBB+
Commercial Paper	K-1

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