

Transaction Update: Ellevio AB

Primary Credit Analyst:

Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@spglobal.com

Secondary Contact:

Gustav B Rydevik, London 00442071761282; gustav.rydevik@spglobal.com

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Rationale

The 'BBB' ratings on Swedish electricity distribution company Ellevio AB's senior secured debt reflect our assessment of Ellevio's 'bbb-' stand-alone credit profile (SACP) plus one notch of uplift for structural enhancements. Ellevio's SACP primarily reflects our view of its excellent business risk profile and aggressive financial risk profile.

None

Business Risk	Financial Risk
<ul style="list-style-type: none">• Focused on low-risk, regulated electricity distribution activities.• Transparent, credit-supportive regulatory framework that results in financial stability during regulatory periods.• Low regulatory reset risk as the current regulatory period runs until Dec 31, 2019 (four-year periods).	<ul style="list-style-type: none">• Relatively weak cash flow ratios, partly due to significant shareholder returns.• Flexibility to adjust shareholder distributions and capital expenditure (capex) to unexpected deterioration of cash flows.• Various structural features designed to increase cash flow certainty for debtholders.

Outlook

The stable outlook on Ellevio's senior secured debt reflects its stable and predictable earnings, which are supported by a favorable regulatory framework. We anticipate that Ellevio will maintain credit measures in line with the current ratings, including FFO to debt of at least 6% based on senior secured debt.

Upside scenario

We currently see the potential for a positive rating action as limited, reflecting our view of Ellevio's financial policy and covenant structures. However, we could raise the rating if credit measures permanently strengthened, supported by a change in the group's financial policy, resulting in a ratio of FFO to debt of sustainably above 8%.

Downside scenario

A negative rating action would primarily relate to any unexpected negative changes to the regulatory framework for Ellevio, which could cause earnings volatility or deterioration, and weigh on credit measures. Material acquisition activity or excessive shareholder returns could also lead us to lower the rating. For example, if leading to FFO to debt decreased sustainably below 6% we could take a negative rating action.

Our Base-Case Scenario

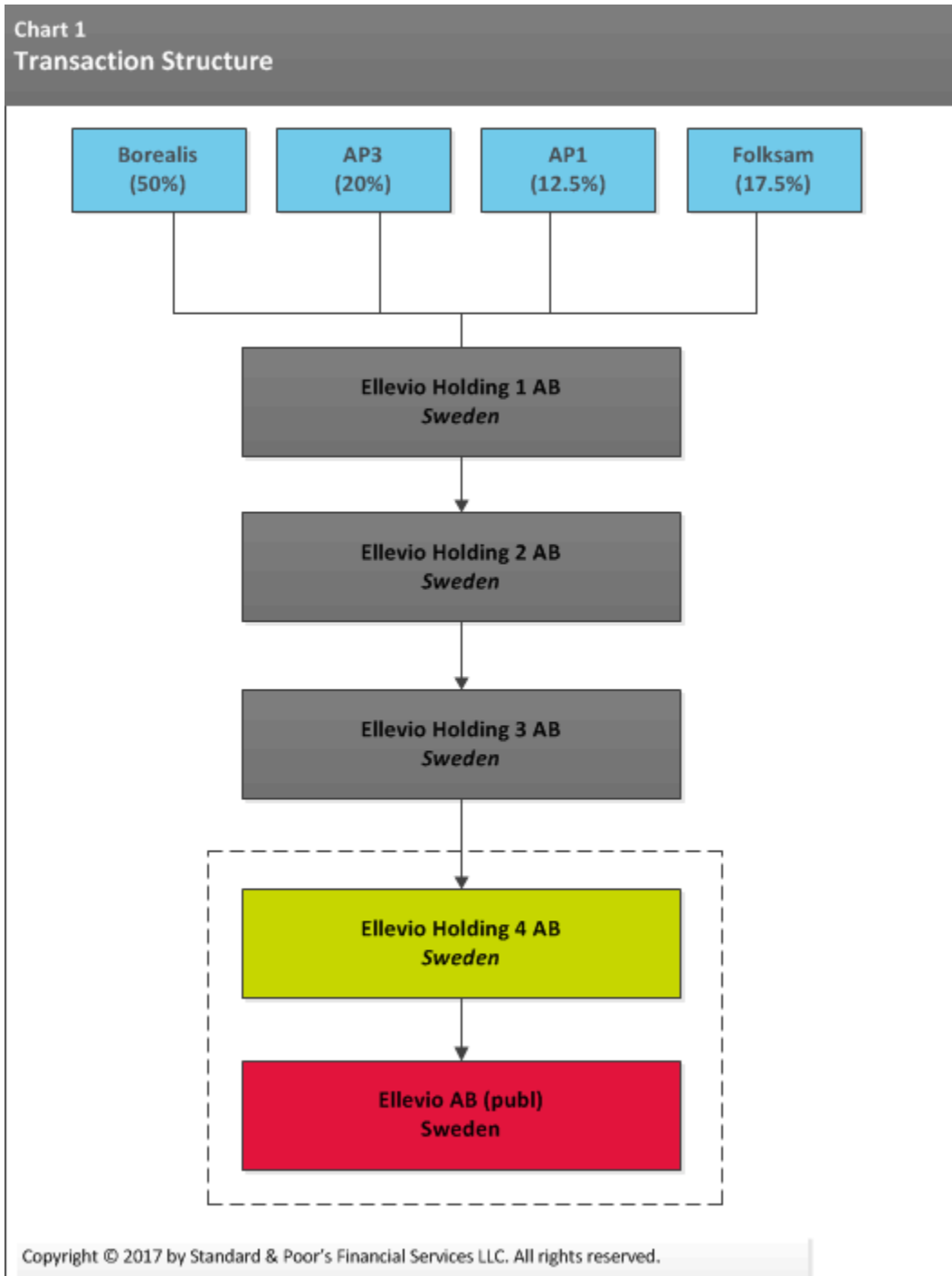
In our base case, we expect that Ellevio will report higher earnings from its regulated electricity distribution business from 2016, in line with the price increases during the current regulatory period. We expect that virtually all of its free

operating cash flows will be distributed to shareholders.

Assumptions	Key Metrics				
<ul style="list-style-type: none"> Price increases during the current regulatory period through the reduction of its regulatory deficit in 2012-2015. We also note that, following an appeal from Swedish DSOs, the Swedish administrative court decided on a WACC of 5.85% for the current regulatory period 2016-2019, which is above the regulator's pre-determined WACC of 4.53%. The court's judgement could, however, be subject to further appeals. Capex of about Swedish krona (SEK) 2.0 billion-SEK2.5 billion annually over the next three years. Shareholder returns of between SEK0.8 billion-SEK 1.2 billion in the next few years, which we assume will be flexible if needed to sustain credit measures. 					
		2015A	2016	2017	2018
	EBITDA margin (%)	55.4	56.0-58.0	59.0-61.0	61.0-63.0
	FFO/debt (%)	5.2	7.0-8.0	7.5-8.5	7.5-8.5
Debt/EBITDA (x)	9.7	8.5-9.5	8.0-9.0	8.0-9.0	

Company Description

Ellevio AB is the second-largest electricity distribution network operator in Sweden, with a 17% market share. Its head office is in Stockholm. It has about 900,000 customers and operates in four different regional areas of Sweden. Ellevio is responsible for delivering electricity to its customers, as well as for the maintenance and development of its network. All of its operations are regulated by the Government and Energy Markets Inspectorate (EI) primarily through the Electricity Act. In 2015, the company had sales of SEK6 billion (€0.6 billion), and EBITDA of SEK3.3 billion. In June 2015, Borealis Infrastructure Management, two of the Swedish states' buffer funds within the national pension system AP3 (20%) and AP1 (12.5%), and Folksam (17.5%) acquired Ellevio from Fortum Oyj for SEK60.6 billion (€6.6 billion), of which SEK32.9 billion (€3.6 billion) was senior acquisition debt.



Structural Features

Table 1

Ellevio AB Supporting Ratings – Liquidity Facility Providers	
Institution	Rating
Canadian Imperial Bank of Commerce, London Branch	A+
Bank of America Merrill Lynch International Limited	A
Bank of Tokyo-Mitsubishi UFJ Ltd.	A+
BNP Paribas Fortis SA/NV	A
Crédit Agricole Corporate and Investment Bank	A
Danske Bank A/S	A
Deutsche Bank Luxembourg S.A.	BBB+
DNB Bank ASA	A+
HSBC Bank PLC	AA-
ING Belgium SA/ NV	A
National Australia Bank Limited ABN 12 004 044 937	AA-
Nordea Bank AB (publ)	AA-
Royal Bank of Canada	AA-
Skandinaviska Enskilda Banken AB (publ)	A+
Société Générale, London Branch	A
Swedbank AB (publ)	AA-
The Bank of Nova Scotia, London	A+
The Royal Bank of Scotland PLC	BBB+

Ellevio AB is the operating company in the Ellevio group, which also includes four holding companies above Ellevio AB. The ultimate owners are international investor Borelais, two Swedish national pension funds (AP3 and AP1), and Swedish mutual insurance company Folksam. Following the refinancing of existing debt, Ellevio AB and its immediate holding company Ellevio Holding 4 AB has formed a ring-fenced financing structure, with Ellevio AB as the borrower. We apply one notch of uplift from Ellevio AB's SACP to the senior secured debt, as the senior secured debt benefits from structural features designed to increase cash flow certainty for the senior secured debtholders. These features include:

- Restrictions on mergers, acquisitions, and asset disposals, and a share pledge in the operating and holding company's assets (to the extent allowed by legislation) and shares.
- Dividend- and debt-restricted payment conditions and a covenanted liquidity structure that should, in our opinion, allow the Ellevio 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.

Table 2

Ellevio AB - Key Features	
Closing date	Sept. 2, 2016
Country of origination	Sweden
Financial covenants	Senior interest cover ratio: 1.2x
	Senior Leverage Ratio: 12x
	Total Leverage Ratio: 13x

Table 2

Ellevio AB - Key Features (cont.)	
Trigger events	Senior interest cover ratio: 1.7x
	Senior Leverage Ratio: 10.75x
	FFO-to-class A debt: 5%
Liquidity facility size (Mil. SEK)	1,500

SEK--Swedish krona.

Business Risk

In our view, Ellevio's business risk profile benefits from fully regulated electricity distribution operations, with natural monopoly market positions in its service areas. We view the Swedish regulatory framework for electricity distribution as stable, transparent, and predictable, with a long track record. This is despite some modifications in methodology between regulatory periods, and some minor weaknesses relating to customer compensation in the case of longer unplanned outages.

We view positively the pre-set regulatory allowed rate of return on capital (i.e. the WACC rate) for the full four-year regulatory period; the operator's ability to adjust tariffs at any time; and its ability to carry over regulatory surplus or deficits from the current regulatory period to the next, which adds to stability in cash flows. We also believe that the allowed return adequately covers operating and capital costs. We recognize that the negative effect on capital compensation, due to the transition to an age-adjusted model for regulatory asset value for the regulatory period from 2016-2019, will be partially mitigated by the introduction of an age-floor for old assets. We also expect Ellevio to be able to increase prices in this regulatory period to recover regulatory deficits from the previous period.

We see the potentially high customer compensation required in case of outages above 12 hours as a minor regulatory weakness; however, due to high cabling and weatherproofing rates, Ellevio's exposure is very limited. We also recognize that the regulatory framework does not cover capex during construction, but rather only once the assets are in operation. However, because the regulated asset base (RAB) is updated every six months, there is no major time lag before assets become part of the RAB. We also view the ongoing legal dispute between the regulator and the distribution system operators (DSOs) about the WACC level for the current regulatory period of 2016-2019 as a source of some uncertainty. However, during the last court proceedings regarding the WACC for the regulatory period from 2012 to 2015 the court ruled in favor of the DSOs. On Dec. 14, 2016, the administrative court decided that WACC should be set at 5.85%, which the regulator has stated it will appeal, because it believes this is an unfair return in such a low risk environment.

Although Ellevio is one of the largest DSOs in Sweden, its size is relatively limited compared with larger international peers. Ellevio has good diversity in terms of customers and geographical service areas. This reduces risks related to unplanned outages due to, for example, weather conditions. We also believe that Ellevio's operating efficiency and profitability are broadly in line with its major peers.

Similar to the two rated Finnish DSOs Elenia Finance Oyj and Caruna Networks Oy, we note that Ellevio also benefits from a strong regulatory framework, providing cash flow stability. Although Caruna has, in our view, slightly weaker

structural features than Ellevio and Elenia, we believe Caruna's financial policy is less aggressive, leading to a higher rating than for Ellevio and Elenia.

Peer comparison

Table 3

Ellevio AB -- Peer Comparison		
Industry Sector: Electric	Ellevio AB	Elenia Finance Oyj
	--Fiscal year ended Dec. 31, 2015--	--Fiscal year ended Dec. 31, 2015--
(Mil. €)		
Revenues	669.3	286.9
EBITDA	370.3	136.9
Funds from operations (FFO)	189.3	102.2
Net income from cont. oper.	1,688.9	(43.9)
Cash flow from operations	293.4	38.1
Capital expenditures	172.9	113.4
Free operating cash flow	120.5	(75.3)
Discretionary cash flow	(96.4)	(75.3)
Cash and short-term investments	13.2	19.1
Debt	3,608.7	1,219.0
Equity	673.1	470.9
Adjusted ratios		
EBITDA margin (%)	55.4	47.7
Return on capital (%)	5.9	3.2
EBITDA interest coverage (x)	2.5	3.8
FFO cash int. cov. (X)	3.8	1.3
Debt/EBITDA (x)	9.7	8.9
FFO/debt (%)	5.2	8.4
Cash flow from operations/debt (%)	8.1	3.1
Free operating cash flow/debt (%)	3.3	(6.2)
Discretionary cash flow/debt (%)	(2.7)	(6.2)

Financial Risk - Aggressive

Ellevio's financial risk profile reflects our forecast FFO to debt of about 7.5%-8.5% through 2019, based on senior secured debt. Although we view debt levels as high, we take into account the low volatility of cash flows--reflecting the strong regulatory framework--which leads us to benchmark credit measures against our low volatility table. We acknowledge likely negative discretionary cash flows related to high capex levels and shareholder returns. We also note that covenants, both for lock-up and default events, would allow higher leverage than we currently forecast in our base case. At the same time, we note that capex should be added to the regulatory assets base and therefore increase allowed regulatory return. We also understand that the company's shareholder returns are flexible and can be reduced if needed to preserve credit ratios (before reaching dividend lock-up levels).

In our comparable ratings analysis, we view negatively the significant portion of, and payments on, the shareholder

funds in the capital structure, which are in the form of shareholder loans. However, we exclude loans from debt in our ratio calculations, reflecting their equity-like features such as deep subordination, maturities beyond all other debt, and the possibility of accruing interest.

Financial summary

Table 4

Ellevio AB -- Financial Summary		
Industry Sector: Electric		
	--Fiscal year ended Dec. 31--	
	2015	2014
(Mil. SEK)		
Revenues	6,128.0	6,006.1
EBITDA	3,392.0	3,378.3
Funds from operations (FFO)	1,734.6	3,291.9
Net income from continuing operations	15,463.4	18.8
Cash flow from operations	2,687.5	3,186.1
Capital expenditures	1,583.2	1,216.9
Free operating cash flow	1,104.3	1,969.2
Dividends paid	1,985.2	1,926.2
Discretionary cash flow	(880.9)	43.0
Debt	33,040.0	3,603.0
Preferred stock	0.0	0.0
Equity	6,162.7	636.7
Debt and equity	39,202.8	4,239.7
Adjusted ratios		
EBITDA margin (%)	55.4	56.2
EBITDA interest coverage (x)	2.5	35.5
FFO cash int. cov. (x)	3.8	53.7
Debt/EBITDA (x)	9.7	1.1
FFO/debt (%)	5.2	91.4
Cash flow from operations/debt (%)	8.1	88.4
Free operating cash flow/debt (%)	3.3	54.7
Discretionary cash flow/debt (%)	(2.7)	1.2
Net Cash Flow / Capex (%)	(15.8)	112.2
Return on capital (%)	5.9	16.6
Return on common equity (%)	454.8	0.2
Common dividend payout ratio (un-adj.) (%)	12.8	0.0

SEK--Swedish krona.

Liquidity

We assess liquidity as adequate, based on Ellevio's adequate headroom under all its financial covenants and available

liquidity sources likely being well in excess of 1.1x liquidity uses over the next 12 months. We assume that sources will continue to cover uses even if EBITDA declines by 10% from our base case. Despite our current forecasts that sources will cover used by more than 1.5x over the next 12 months and more than 1.0x over the next 24 months, we assess liquidity as adequate. This is because Ellevio currently has a limited track record of accessing the capital markets, which leads us to assess its market access as satisfactory rather than high, and bank relationships as sound rather than solid.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> • Cash of SEK63 million; • FFO of about SEK2.7 billion; and • Undrawn bank lines of about SEK11.6 billion. 	<ul style="list-style-type: none"> • Amortizing debt maturities of about SEK1.8 million; • Capex of SEK2 billion; and • Roughly SEK1 billion of shareholder returns.

Covenants

The credit facility contains debt to EBITDA covenants for lock-up and default of 10.75x and 12.0x, respectively. The interest cover covenants for lock-up and default are 1.7x and 1.2x, respectively. We estimate that the group has headroom under both its trigger and events-of-default covenants for leverage and interest costs. Ellevio complies with the debt-maturity limitations stipulated in the documentation, and also complies with all of its financial covenants on a historical basis. The company has yet to publish its first compliance certificate since the transaction closed on Sept. 2, 2016, however, based on our forecasts, we believe Ellevio will have comfortable headroom under its financial covenants.

Debt maturities

2017: SEK1,176 million

2018: SEK1,176 million

2019: SEK1,176 million

2020: SEK10,740 million

After 2020: SEK19,272 million

Reconciliation

Table 5

Reconciliation Of Ellevio AB Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. SEK)

--Fiscal year ended Dec. 31, 2015--

Ellevio AB reported amounts

	Debt	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	52,984.5	3,275.3	1,674.6	1,338.1	3,275.3	2,635.9

Table 5

Reconciliation Of Ellevio AB Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. SEK) (cont.)						
S&P Global Ratings adjustments						
Interest expense (reported)	--	--	--	--	(1,338.1)	--
Interest income (reported)	--	--	--	--	0.2	--
Current tax expense (reported)	--	--	--	--	(294.0)	--
Operating leases	495.5	116.7	34.3	34.3	82.5	82.5
Postretirement benefit obligations/deferred compensation	--	--	--	--	8.7	(30.9)
Surplus cash	(120.8)	--	--	--	--	--
Non-operating income (expense)	--	--	0.2	--	--	--
Debt - Accrued interest not included in reported debt	107.5	--	--	--	--	--
Debt - Shareholder loans	(20,426.5)	--	--	--	--	--
Total adjustments	(19,944.4)	116.7	34.4	34.3	(1,540.8)	51.6
S&P Global Ratings adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	33,040.0	3,392.0	1,709.0	1,372.4	1,734.6	2,687.5

SEK--Swedish krona.

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses - February 24, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Transaction Structure Methodology - September 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology - September 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 - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- Criteria - Structured Finance - General: Counterparty Risk Framework
- Methodology And Assumptions - June 25, 2013

Related Research

- Swedish Electricity Distributor Ellevio AB's €10 Billion Debt Program Assigned 'BBB' Rating; Outlook Stable, Sept. 26, 2016

Ratings Detail (As Of January 13, 2017)

Ellevio AB

Senior Secured	BBB
Senior Secured	BBB/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

Additional Contact:

Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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