5 May 2020 Corporates

Lyse AS
Norway, Utilities

SCOPE BBB+ STABLE

Corporate profile

Lyse AS is a Norwegian utility, fully owned by a group of 14 municipalities in south-western Norway. The company operates in three business areas: energy, power grids and telecommunications. Lyse is the country's sixth-largest hydroelectric power producer. Its experience in building and operating power grid infrastructure has also enabled it to establish itself as a national leader in fibre-optic broadband.

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	11.6x	7.6x	6.6x	7.3x
Scope-adjusted debt (SaD)/EBITDA	2.3x	3.5x	4.2x	3.8x
Scope-adjusted FFO/SaD	34%	15%	15%	19%
Free operating cash flow (FOCF)/SaD	11.9 %	-4.8 %	-6.5%	-1.2%

Rating rationale

Scope Ratings has a BBB+/Stable corporate issuer rating on Lyse. The short-term rating is S-2 and the senior unsecured rating is BBB+.

The rating is supported by Lyse's diversified business model, with operations in energy production, power distribution and telecommunications. An increasing share of EBITDA is currently being generated by a combination of robust infrastructure segments, such as monopolistic power distribution and fibre-optic television and broadband services. At the same time, the share of more volatile energy-producing segments is decreasing (i.e. from around 60% in 2018 to an estimated 40% in 2020) due to lower power prices and lower produced volumes.

Although the power production segment will be negatively affected by lower prices this year, we note that it is supported by a low-cost hydro portfolio and a relatively large hydro reservoir capacity, which help to optimise production and sales in the marketplace. In addition, the company started this year with an acceptable hedging level for 2020 and 2021, secured at much higher prices than the market prices indicate today as of early Q2). This mitigates downside risk for the archived prices which we expect Lyse will be able to achieve for the full year.

Lyse's financial performance and credit metrics in 2019 were robust, but we expect them to deteriorate this year due to lower power prices and continued heavy investment in the company (telecoms related). Still, some of the capex planned for 2020 can be postponed or held back, as a notable part was earmarked for expansionary investments and not fully committed. Nevertheless, our base case assumes negative free operating cash flow (FOCF) in 2020, and further negative effects of the agreed dividend pay-out this year. As a result, we expect the leverage to increase to around 4x this year, a ratio which includes the company´s subordinated shareholder loan. Overall, we foresee Lyse's financial risk profile weakening this year, which is the main constraining factor in the current rating assessment. However, Scope acknowledge also management indications that it could reduce capex and further increase production volumes this year, in order to mitigate the negative effects of lower power prices than in 2019 and maintain its financial targets.

Ratings & Outlook

Issuer rating	BBB+/Stable
Short-term rating	S-2
Senior unsecured rating	BBB+

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Related methodology

European Utility Methodology, March 2020

Corporate Rating Methodology, Feb 2020

Government Related Entities Methodology, July 2019

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Outlook

The Stable Outlook reflects our expectation that Lyse will maintain its diversified business model (generation, grid and telecoms) and strong liquidity that fully covers both shorter-term debt maturities and the current investment programme. It also assumes that the expected negative pressure on credit metrics in 2020 will be temporary and that the company will operate in an average leverage range of between 3-4x in the medium term. Lyse's flexibility and willingness to reduce expansionary investments (if needed) in order to achieve financial targets, provide comfort. The Outlook also reflects our expectation that Lyse's ownership structure will remain unchanged.

A rating upgrade could be warranted if cash flows prove higher than our estimates, due to consistently higher achieved market prices or lower capex, which would translate into sustainable positive free cash flow, deleveraging, and an improved financial risk profile exemplified by Scope-adjusted debt (SaD)/EBITDA below 3.0x on a sustained basis.

A negative rating action is possible if Lyse's financial risk profile weakens going forward due to lower wholesale prices or debt-financed transactions or investments, resulting in leverage of above 4.0x for a prolonged period.

Rating drivers

Positive rating drivers	Negative rating drivers
• Robust and diversified business model, given its monopolistic structure in power transmission, profitable telecoms business, and the power generation portfolio's advantageous position in the merit order system • Profitable and environmentally friendly hydropower production with a large reservoir capacity • Committed, long-term owners (14 municipalities)	• Volatility of achievable prices in power generation • Telecoms business currently in a relatively large investment phase, which puts pressure on cash flow • Limited diversification by geographical pricing market and relatively high asset concentration risk in Lyse's major hydro plants

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Reduced investments and positive free cash flow in the long term, which maintain credit metrics (i.e. SaD/EBITDA staying below 3x)	• Large debt-financed acquisition of other businesses or significantly lower prices, resulting in a weakened financial risk profile (i.e. SaD/EBITDA above 4x) on a sustained basis

Financial overview

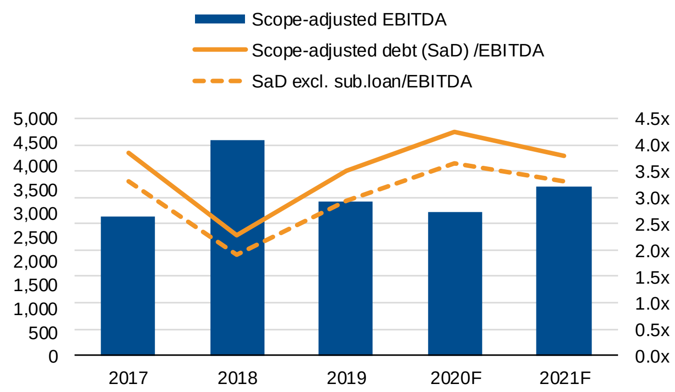
			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	11.6x	7.6x	6.6x	7.3x
SaD/EBITDA	2.3x	3.5x	4.2x	3.8x
Scope-adjusted FFO/SaD	34%	15%	15%	19%
FOCF/SaD	11.9 %	-4.8 %	-6.5%	-0.5%
Scope-adjusted EBITDA in NOK m				
EBITDA	4,336	3,244	3,020	3,554
Add: operating lease payments in respective year	201	-	-	-
Scope-adjusted EBITDA	4,537	3,244	3,020	3,554
Scope-adjusted funds from operations in NOK m				
EBITDA	4,336	3,244	3,020	3,554
Less: (net) cash interest per cash flow statement	-329	-365	-457	-487
Less: cash tax paid per cash flow statement	-616	-1,211	-706	-501
Add: depreciation component, operating leases	165	0	0	0
Add: other items	-28	-4	10	10
Scope-adjusted funds from operations	3,528	1,664	1,867	2,576
Scope-adjusted debt in NOK m				
Reported gross financial debt	14,402	15,967	17,232	17,660
Less: cash, cash equivalents	-5,104	-4,718	-4,554	-4,417
Add: cash not accessible	121	67	67	67
Add: pension adjustment	86	65	65	65
Add: operating lease obligations	776	0	0	0
Add: other provisions	35	11	11	11
Scope-adjusted debt	10,315	11,392	12,821	13,386

Operational developments since Scope's previous rating report

Low hydro-power production in 2019

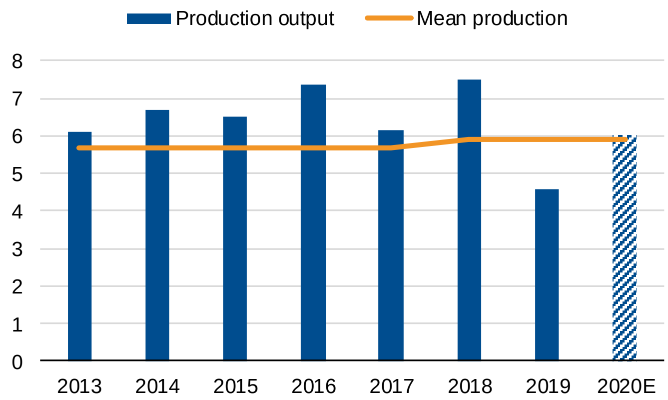
Lyse's overall financial performance in 2019 did not fully meet our expectations due to a lower contribution from its hydropower production. Although we expected a much lower volume in 2019 than the record level achieved in 2018, the actual result of only 4.6TWh of electricity production in 2019 was still the main reason for lower cash flow. The reason for the lower production volume was a combination of a low reservoir level going into the year and expectations of higher prices ahead. The other business segments developed largely in line with our expectations, with the telecoms segment once again showing healthy and strong EBITDA growth. As a result, this segment now accounts for around 40% of group EBITDA. If we add the regulated grid businesses of 10%, Lyse's EBITDA was more or less equally generated by its infrastructure and the more volatile power production in 2019.

Figure 1: Scope-adjusted leverage development (NOK m)



Source: Scope estimates

Figure 2: Hydro-power production level (in TWh)



Source: Scope, Company

In terms of cash flow, Lyse was also negatively affected by higher capex spending than we expected (this was also higher than in the previous year). Combined with the slightly increased dividend, negative discretionary cash flow resulted in SaD/EBITDA rising to around 3.5x, up from a more conservative 2.3x at YE 2018. Liquidity remains sufficient at YE 2019, with more than NOK 6.5bn in undrawn credit lines, which surpass near-term debt maturities by good margins, see Figure 4.

Updated Scope forecast

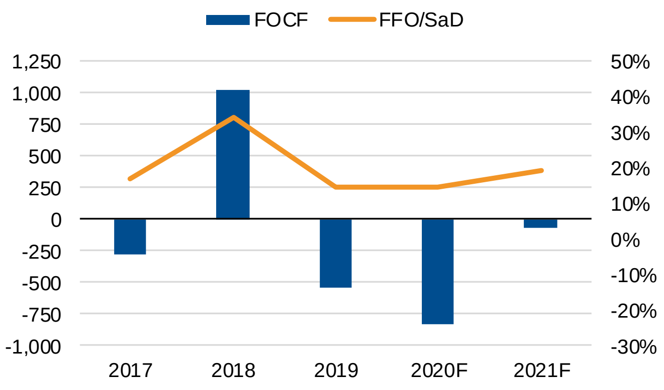
Higher hydro production, but negative FOCF expected in 2020

We have adjusted the company's medium-term forecast, based on significantly lower electricity market prices in the Nordic market and operational updates from the company since our last review. For 2020, the lower spot and forward price curve for electricity is mitigated by Lyse's previous hedging contracts at higher levels. Post 2021, the company could be more severely impacted if the lower price regime prevails. In addition to the uncertainty around actual achieved power prices, Lyse is in control of large water reservoir capacity, enabling yearly variations in the production volume output. We expect the company to be 'forced' to produce more in 2020 than in 2019, as its previous strategy of waiting for higher prices has not been completely successful and reservoir levels are filling up. Our base case assumes an annual produced volume of 6TWh in 2020, significantly up from 2019, but more in line with the mean production level.

We still expect heavy investment in the telecoms business, followed by higher investment in grid infrastructure from 2021. As a result, our base case foresees negative operating free cash flow in the next two years, putting pressure on credit ratios.

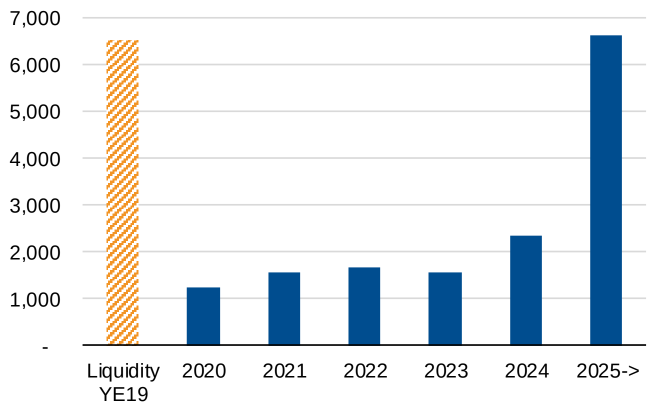
In addition to ordinary dividend distribution, the municipality owners also receive a cash contribution from the subordinated shareholder loan, which includes an amortising element and interest. The subordinated shareholder loan is accounted for as debt in our key ratios. Excluding the loan (NOK 1.9bn), Scope-adjusted leverage would have been around 3x at YE 2019 (instead of 3.5x).

Figure 3: Cash flow development (NOK m on LHS)



Source: Scope estimates

Figure 4: Liquidity & debt maturity profile, YE 2019 (NOK m)



Source: Scope, Company

Summary of business and financial risk profile

Our BBB+ business risk profile assessment of Lyse remains stable, supported by the increased share and importance of cash flow from its telecoms and grid segments. We continue to view the company's business risk profile as better than its financial risk profile. Although the company was boosted by relatively high electricity prices in the last two years, power prices this year are substantially lower. This highlights the importance of a diversified organisational structure for a company's business risk profile.

Lyse's financial risk profile is under some downward pressure due to negative free cash flow generation this year, which will increase the leverage ratio and worsen other credit-related ratios as well. Although a significant rise in power prices is not imminent at the moment, we expect Lyse's financial risk profile to improve in 2021, based on a higher produced electricity volume, and further profitability improvements in the telecoms and grid business.

Supplementary rating drivers

We used a bottom-up approach to analyse Lyse's parent support as per our Government Related Entities Methodology. The one-notch rating uplift assigned for municipality ownership has not changed. From 1 January 2020 the company is 100% owned by 14 Norwegian municipalities (previously 16, due to the merger of Stavanger and the smaller Rennesøy and Finnøy municipalities), which we see as one group with a common interest.

We make no adjustment for financial policy. However, management targets a minimum credit rating of BBB+ and is thus implicitly aware of which credit ratios it needs to maintain at certain levels. In addition, management's liquidity strategy includes the stated ambition that cash should cover operational and investment activities as well as debt maturities and dividend in the next nine months.

Long-term and short-term debt ratings

The senior unsecured rating is in line with the issuer rating. The S-2 short-term rating reflects the company’s sufficient short-term debt coverage and good access to banks and debt capital markets.

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