18 January 2019

Corporates

Akershus Energi AS
Norway, Utilities

SCOPE BBB STABLE

Corporate profile

Akershus Energi AS is a medium-sized Norwegian producer of hydroelectric power, with annual production of around 2.3TWh. It operates in three segments: hydropower production, district heating, and green infrastructure. The company owns and operates hydroelectricity plants mainly located along the longest river in Norway, Glomma, but also has wholly and partially owned power stations in southern Norway. The company is 100% owned by Akershus County Municipality.

Key metrics

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	8.5x	9.3x	10.2x	9.4x
Scope-adjusted debt (SaD)/EBITDA	2.6x	2.2x	2.0x	2.4x
Scope-adjusted FFO/SaD	31%	24%	15%	21%
FOCF/SaD	17.5 %	22.9 %	2.1 %	7.9 %

Rating rationale

Scope Ratings assigns a corporate issuer rating of BBB to Norway-based Akershus Energi AS. The Outlook is Stable. Scope also assigns an S-2 short-term rating and a BBB long-term rating to the company's senior unsecured bonds.

Akershus Energi's business risk profile is positively affected by its low-cost hydropower assets, which have a strong position in the merit order system, thus helping secure utilisation. Together with an increasingly profitable district heating business, Akershus Energi has generated above-average group profitability margins (>55% in recent years) and uses forwards to hedge around 30-50% of its shorter-term production volume. Akershus Energi is strongly exposed to the energy market, which is both volatile and cyclical; thus we view favourably its initiatives to improve cash flow predictability through power-price hedging and increased infrastructure investment. Its hedging strategy was effective against declining power prices between 2012-16, but lately (in the upward power price trend during 2017 and 2018) it has achieved prices below the market average. Limiting factors for Akershus Energi's business risk profile, in addition to its industry risk and price exposure for unhedged production output, include modest segmentation and limited water reservoir capacity. Its main hydro assets are run-of-river plants, making them less flexible and exposing its production output more to dry hydrological years than peers with a larger reservoir capacity.

When assessing Akershus Energi's financial risk profile, we highlight the company's positive free operating cash flow (before dividends), indicating its ability to fund investments with internally generated cash flow over the cycle. The leverage ratio has in recent years stayed below 3x, which we forecast to continue into the medium term. Also positive for the financial risk profile is the strong interest coverage and solid liquidity via the limited need for debt refinancing in the near future. Liquidity is also positively influenced by access to financial assets that can be divested to partially fund its growth plans, coupled with adequate access to bank and capital markets. The financial risk profile is currently constrained by the company's ambition to increase expansionary investment, which is likely to result in weaker credit metrics (compared to current levels) in our medium-term base case projection.

Ratings

Corporate ratings	BBB
Outlook	Stable
Short-term rating	S-2
Senior unsecured rating	BBB

Lead analyst

Henrik Blymke
+47 21 62 31 41
h.blymke@scoperatings.com

Related methodologies

European Utilities, January 2018

Government Related Entities, July 2018

Corporate Rating Methodology, January 2018

Scope Ratings GmbH

Haakon VII's gate 6
0161 Oslo
Tel. +47 21 62 31 41

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

The BBB issuer rating reflects a standalone credit quality of BBB- plus a one-notch uplift based on our assessment of the owner, Akershus County Municipality, which we deem to have both the willingness and capacity (in accordance with Scope's Government Related Entity Methodology) to provide support if needed. When assigning the standalone credit rating for the company, we have for the moment put slightly more emphasis on the company's weaker business risk profile than the stronger financial risk profile, due its business mix characteristics and growth ambitions.

Outlook

The Stable Outlook reflects our expectation that Akershus Energi's financial and business risk profiles will remain relatively unchanged in the medium term. The Outlook assumes that i) a substantial share of EBITDA will continue to stem from hydropower production; ii) a medium-to-high share of anticipated power production will remain hedged; and iii) management will continue to act prudently in its green infrastructure and growth investments plans, preserving its financial risk profile and reducing volatility in power production. The Outlook also includes our expectation that Akershus Energi will remain 100% owned by a Norwegian county municipality.

A positive rating action is possible if Akershus Energi uses excess free cash flow for paying down debt rather than for high dividends and expansionary investment, which would result in an improved financial risk profile over time, exemplified by a Scope-adjusted debt (SaD)/EBITDA of below 2.2x on a sustained basis.

A negative rating action could be warranted if more aggressive debt-financed growth is pursued or power prices fell substantially, leading to negative free operating cash flow (FOCF) and weaker credit metrics on a sustained basis, e.g. SaD/EBITDA above 3.5x.

Rating drivers

Positive rating drivers	Negative rating drivers
• Highly profitable and cost-efficient hydropower production leading to strong EBITDA margins • Hedging policy and infrastructure investment mitigating some inherent business volatility • Committed, long-term majority owner with clear willingness and capacity to provide support if needed	• Power price exposure and volatility of unhedged European power production • Limited water reservoir capacity, as power assets are mainly run-of-river plants • Low diversification by segments and geographical pricing markets

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Excess free cash flow used to pay down debt, resulting in a sustainable improvement in credit metrics (e.g. SaD/EBITDA below 2.2x over time) • Increasing EBITDA share of the more stable green infrastructure business, which could lead to lower volatility or an improved business risk profile	• Materially lower achieved power prices and reduced hedging levels • Weaker financial risk profile, exemplified by negative FOCF and a SaD/EBITDA above 3.5x

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	8.5x	9.3x	10.2x	9.4x
SaD/EBITDA	2.6x	2.2x	2.0x	2.4x
Scope-adjusted FFO/SaD	31%	24%	15%	21%
FOCF/SaD	17.5 %	22.9 %	2.1 %	7.9 %
Scope-adjusted EBITDA in NOK m				
EBITDA	447	542	638	605
Add: operating lease payments in respective year	0	0	0	0
Scope-adjusted EBITDA	**447**	**542**	**638**	**605**
Scope-adjusted funds from operations in NOK m				
EBITDA	447	542	638	605
Less: (net) cash interest per cash flow statement	-53	-60	-62	-64
Less: cash tax paid per cash flow statement	-53	-106	-312	-240
Add: depreciation component, operating leases	0	0	0	0
Add: other items	28	-89	-65	10
Scope-adjusted funds from operations	**369**	**287**	**198**	**311**
Scope-adjusted debt in NOK m				
Reported gross financial debt	1,600	1,771	1,742	1,878
Less: cash, cash equivalents	-451	-618	-477	-438
Add: cash not accessible	9	18	18	18
Add: pension adjustment	13	1	1	1
Add: operating lease obligation	3	3	2	2
Scope-adjusted debt	**1,174**	**1,175**	**1,287**	**1,462**

Business risk profile

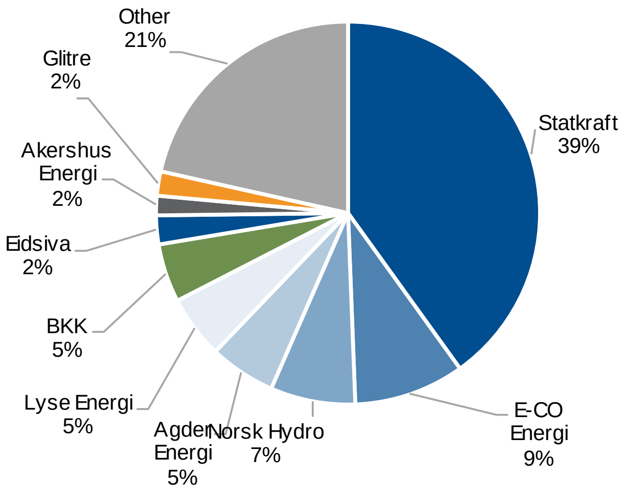
In accordance with our utilities rating methodology, industry risk and competitive position are analysed separately for the business risk profile assessment. For a more detailed industry fundamental review, see our latest report dated January 2018.

Industry risk

90% of group EBITDA from power production

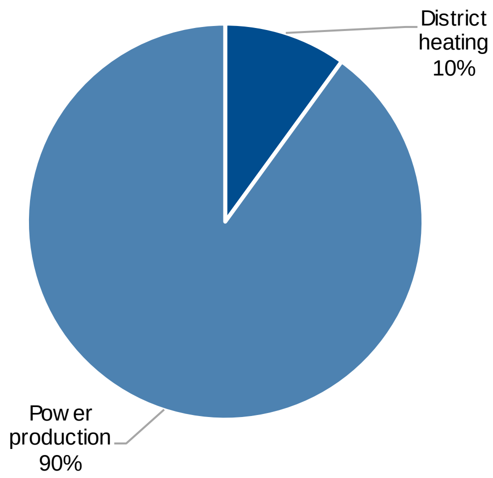
Most of Akershus Energi's EBITDA comes from power generation (90%), which therefore dominates our overall blended industry risk assessment of BB. In our view, the European power generation market is highly cyclical and has medium entry barriers, whereas the district heating industry is less cyclical, but its variable prices are linked to electricity market prices. The green infrastructure exposure has a neutral effect on our overall industry risk assessment given its minimal contribution to overall group profitability. Other investments held (or to be held) through associated companies, to diversify away from high power-production risks, are excluded from our EBITDA calculation and thus our weighed industry risk profile. Should these associated companies' profitability become material in the future, we will explicitly comment on the overall risk impact.

Figure 1: Norway's main hydro generation companies



Source: Company reports, Statistics Norway (SSB), Scope

Figure 2: Normalised segment breakdown by EBITDA



Source: Company, Scope

Competitive position

Akershus Energi's competitive position in its two main segments is supported by:

- Strong profitability in its low-cost hydro power production unit and district heating business;
- Favourable position in the merit order system for power production, thus securing utilisation of generation output; and
- Partial mitigation of pricing risk in power production through hedging.

Nevertheless, Akershus Energi's competitive position is hampered by:

- Limited geographical diversification into different pricing areas and low segmentation into other utility areas other than district heating;
- Some volume risk in dry hydrological years and less production flexibility due to limited water reservoir capacity; and
- A large exposure to power price volatility through its unhedged power production, given its high EBITDA contribution.

Low hydropower production cost secures utilisation

With annual hydropower production of about 2.3TWh, Akershus Energi is considered a small power generator in the Nordic power market. Despite this, the company has a strong position in the power merit order system, thanks to the comparatively low cost of hydropower electricity generation.

Mainly run-of-river plants – limited water reservoir capacity

Akershus Energi mainly owns and operates run-of-river power plants, but is also a partial owner in power plants with some reservoir capacity. However, compared to companies with a larger reservoir capacity, Akershus Energi's run-of-river power stations provide less flexibility to adjust and optimise production, exposing it to more volume risk in dry hydrological years. That said, looking at historical data, and with the 2018 summer being the driest in history, annual production levels have not fluctuated by more than 5%-10%.

The group has a regional focus on district heating through subsidiary Akershus Energi Varme AS (67% owned). Long-term Swedish infrastructure investment fund Infranode AB became a co-owner in 2017, providing a new source of equity financing for further growth. The sales volume in district heating was 173GWh in 2017, representing a 3.1% market share of Norway's total volume. Customers are primarily public sector or commercial companies.

Seeking diversification through infrastructure

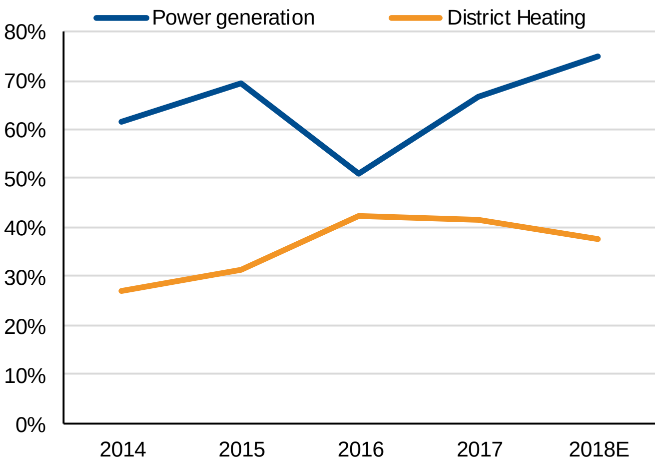
Although hydropower production and district heating are the only segments that currently contribute to EBITDA, the group is also active in green infrastructure. We recognise the company's ambition to diversify into more stable and less cyclical businesses like real estate investment and data centres, but so far this has had a limited impact on our overall business risk profile assessment.

The company has 19 hydropower plants: nine fully owned and 10 partly owned. The largest plant comprises 12% of the group's annual production, while the three largest make up approximately 33% (combining their various assets and turbines). Hence, the incremental effect on cash flow upon a standstill of one of the larger plants would be manageable, in our view. We also note that many of its wholly owned power plants have had extensive maintenance in recent years, thus improving security and overall efficiency. While an adequate level of asset concentration risk contributes positively to the overall diversification analysis, geographical and segmentation factors weigh negatively.

High group profitability margins in both key segments

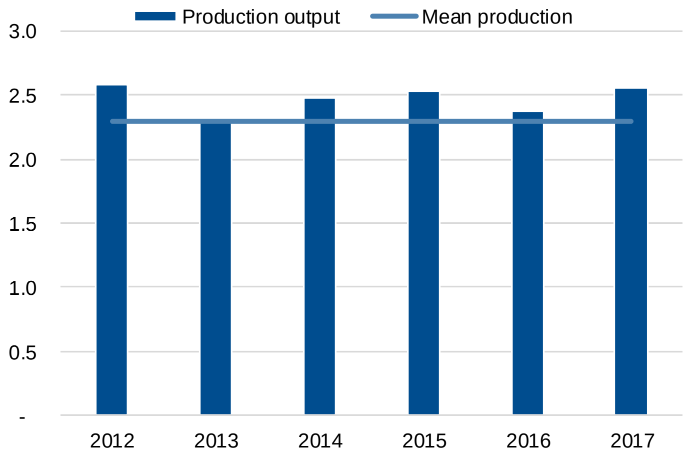
Akershus Energi's profitability margins are high due to large hydropower production share. The group EBITDA margin has averaged more than 55% in the last four years, but with some volatility – attributable to hydropower production volume and achievable prices. The district heating business is less volatile and has recently trended upwards, now also providing the group with good returns (+40% EBITDA). For the medium term, we predict a sustained overall EBITDA margin of around 60%, based on the latest forward prices in the market and the current hedging prices provided by the company.

Figure 3: EBITDA margin development by main segment



Source: Company, Scope

Figure 4: Yearly Power generation in TWh



Source: Company, Scope

Hedging policy to reduce underlying volatility

In terms of prices and volume hedging of hydropower production, the company's policy could lead to 60% hedging of anticipated production volume. Historically, shorter-term hedging levels have been at around 30-50%, while the longer-term positions have been at lower levels with some variations. Its hedging policies aim to achieve high predictability in cash flow after tax in Norwegian krone, thus also hedging the euro exposure partially (but separately from the volume hedge). The company is currently reviewing its hedging strategy. The reason is to reflect the stabilising effects from district heating and new, potential bilateral long-term customer contracts in the future. As a result of the above and acknowledging the tax effects on economic rent ('grunnrente') in Norway, we expect Akershus Energi's total hedged share of short-term power generation to remain in the medium-to-high category.

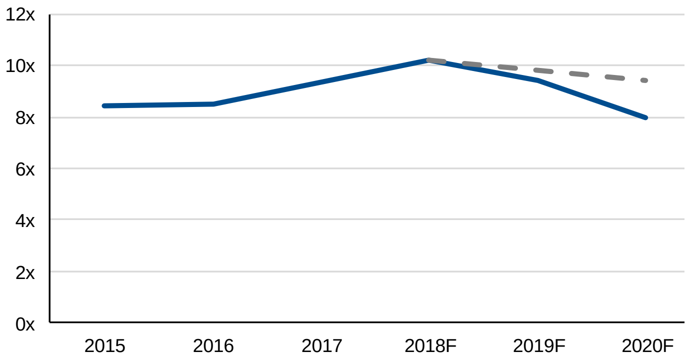
Financial risk profile

Leverage ratios fluctuating between 2-3x

Akershus Energi's credit profile and financial metrics are less volatile than one would expect for a company relying on hydropower production. This is due in part to the company's hedging policies as well as improved profitability in district heating. Going forward, the ambition is to further diversify and reduce volatility through a higher return on investment for infrastructure and, potentially, improve diversification via minority-share acquisition of wind power assets.

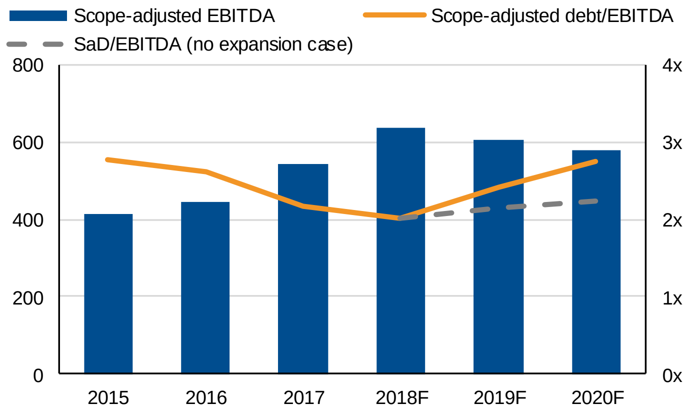
With Scope-adjusted leverage and interest cover ratios respectively ranging between 2-3x and 8-10x in the last few years, the financial risk profile comfortably meets the investment grade criteria under our utilities rating methodology. Operating cash flow has been strong, but years with higher investment levels have resulted in negative discretionary cash flow, due to relatively high dividend-payout levels.

Figure 5 – EBITDA net interest coverage development



Source: Company, Scope

Figure 6 – Scope-adjusted debt/EBITDA



Source: Company, Scope

Akershus Energi's operating cash flow levels in recent years have not only depended on power prices achieved, but also fluctuated based on taxes paid. Due to a primary focus on power production, Akershus Energi's taxes vary more widely (depending on the power price) than those of a utility with a more vertically integrated business, e.g. with a regulated grid segment as well. That Akershus Energi also had investments that were tax-deductible when energy prices were low in 2014-16 also had an effect and helped to keep operating cash flow at acceptable levels in that period.

Lower capex has enabled more investment in infrastructure and marketable securities

Akershus Energi has reduced maintenance investment since 2016, positively affecting discretionary cash flow in both FY 2016 and FY 2017 despite a relatively high dividend payout. Although the company has been accumulating a higher absolute gross debt level (despite positive FOCF), net debt has not kept pace, as some cash has been placed in real estate funds and money market funds, awaiting new investments.

At the end of June 2018, the company's net debt increased slightly, driven by higher taxes, dividends, and cash paid for energy futures. Scope-adjusted leverage stands at around 2.3x as of the end of June, which we expect to decline to around 2.0x until YE 2018.

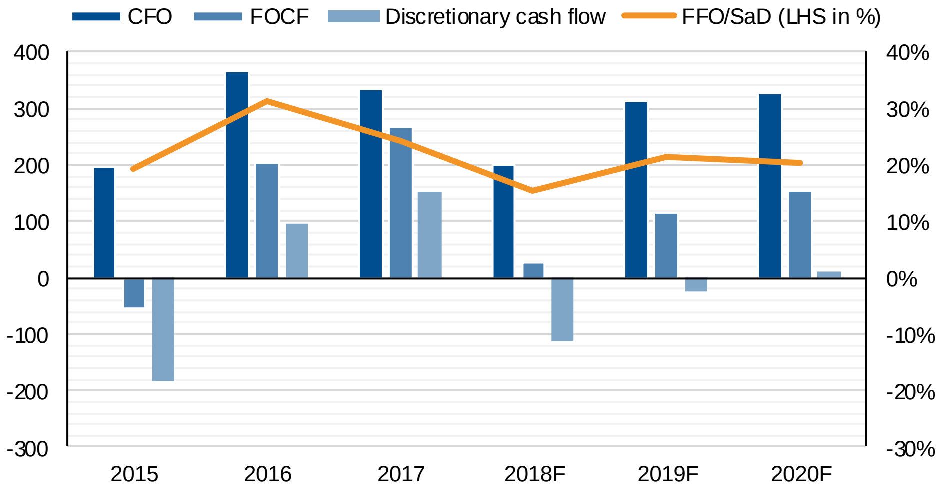
Operating cash flow to cover ordinary investment and dividend

Going forward, we estimate Akershus Energi will generate around NOK 300m annually in funds from operations (FFO) during a normal year. Our forecast from 2019 assumes mean production levels, following a 2018 level that is estimated to be slightly below the mean. We aligned the achieved power prices with both current market forward prices and hedging information provided by the company. Based on our medium-term projections, we expect Akershus Energi to largely cover capex and dividends, and thus for indebtedness to remain relatively unchanged in a no-growth-ambition scenario.

Indebtedness level depending on new investment opportunities

However, management is considering the possibility of smaller acquisitions to add capacity, which makes our base case forecast slightly more investment-aggressive. We assume the company will add more production capacity in the long term, most of which will be new onshore wind power. The investment will not automatically increase Scope's estimated EBITDA, because the strategy also includes investing into companies in which Akershus Energi will own less than 50%. We assume that investments will be financed partially through its real estate investment funds and marketable securities, thus approximately halving the need for new debt.

Figure 7: Cash flow development

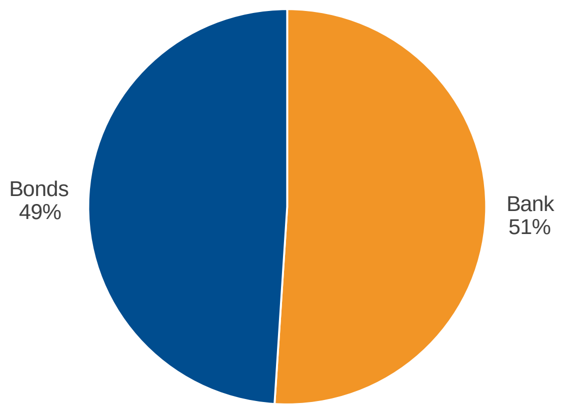


Source: Company, Scope estimates

Limited debt refinancing needs before 2021

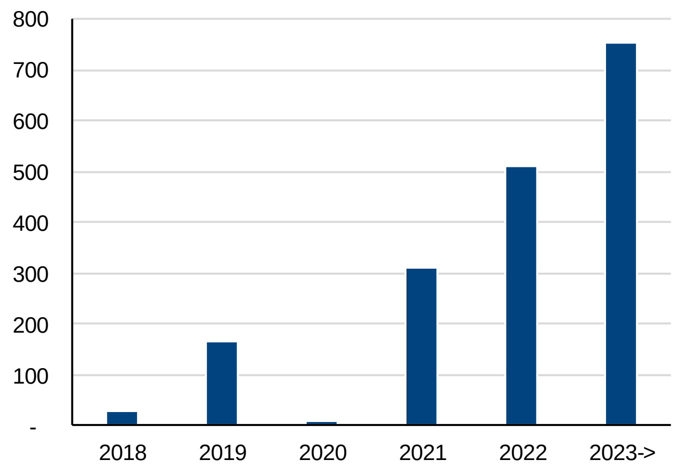
As of H1 2018, the company had only NOK 19m in cash, but NOK 428m in marketable securities, mainly money market funds with a short duration (1-2 days) and very strong credit profile (such as Norwegian government bonds). In addition, the company has NOK 475m in long-term committed credit lines (maturing in 2021) and NOK 425m in short-term RCF drawing lines that are renewed yearly. This is far more than the debt maturities for the next three years.

Figure 8: Funding structure



Source: Company, Scope

Figure 9: External debt maturity profile



Source: Company, Scope

S-2 short-term rating

The company meets Scope's definition of short-term debt coverages with good margins due to the low level of short-term borrowing. However, we consider access to funding to be merely adequate, due to the dependence on only a few banks and lower bond-issuing activity than most of its relevant peers. Still, for the overall assessment, the better S-2 short-term rating is justified.

Supplementary rating drivers

Enhanced official financial strategy expected

Financial policy

Today's financial official policy from Akershus Energi stipulates that the company should have sufficient long-term and short-term financial flexibility and be viewed by investors as a company with a strong credit profile. Although, the group's official financial strategy should ideally be more detailed and precise in our view, we expect this to change, as management plans to publish a more detailed financial policy in due course, which could also include a (minimum) rating target reference.

Ownership and parent support

One-notch rating uplift from standalone rating

The company is fully owned by Akershus County Municipality, which is located near Oslo and has many inhabitants with stable taxable income.

In 2020, Akershus County will merge with two other counties to create a larger unit called Viken. This is part of a Norwegian government initiative to strengthen the counties' authority and expertise by making them larger and more robust. Viken will have 1.2m residents and will become the most populous county in Norway.

For Akershus Energi this means it will be 100% owned by Viken County instead of the smaller Akershus County. There is currently no indication this will result in a change in strategy or dividend policy.

Uplift in line with new GRE methodology and peers with similar ownership structure

We have used our government related entities methodology to assign a one-notch uplift to Akershus Energi's standalone credit rating. The one-notch uplift for ownership is in line with other Scope-rated Norwegian utilities with majority municipality ownership and without explicit guarantees. Based on the new and more transparent methodology, we assess both the overall capacity and likelihood of the owner to provide support at 'medium', which includes an evaluation of strategic importance, ease of substitution and default implications.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer