Sunnhordland Kraftlag AS
Norway, Utilities

STABLE
BBB

Corporate profile

Sunnhordland Kraftlag (SKL) is a Norwegian utility founded in Stord, Norway in 1946. The company has transformed into a pure-play hydropower producer in recent years with own electricity production of about 2.5 TWh. SKL owns and operates 24 production facilities, mainly located in the counties Rogaland and Vestland in Norway. In addition, SKL has ownership interests in other hydropower plants in the region. SKL is directly owned by Haugaland Kraft (59.7%), BKK (38.2%) and Stord Municipality (2.1%).

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	44.6x	5.7x	46.4x	24.0x
Scope-adjusted debt (SaD)/EBITDA	1.0x	10.9x	0.5x	2.1x
Scope-adjusted funds from operations/SaD	30%	-14%	205%	-1%
Free operating cash flow/SaD	-27%	-37%	137%	-32%

Rating rationale

Scope has assigned a BBB/Stable issuer rating on Sunnhordland Kraftlag AS along with a BBB senior unsecured debt rating.

The issuer rating reflects a stand-alone credit quality of BBB- and a one-notch uplift based on our assessment of parent support. The uplift is driven by the anticipated capacity and willingness of the indirect municipality owners to provide support, assessed in accordance with our Government Related Entities methodology.

With regard to SKL's business risk profile, we note positively its low-cost, environmentally friendly hydropower production (positive ESG factor). The company also has significant reservoir capacity (about 50% of annual production) that provides its power generation segment with more flexibility, which is advantageous when operating in a market that has volatile prices. Limiting factors for SKL's business risk profile include the electricity price exposure to its unhedged production output, and the volatile nature of the power generation industry, coupled with low diversification by segment and geographical pricing market. Its high dependency on its largest power plants, which account for a significant share of its annual production, is also a business risk constraint.

When assessing SKL's financial risk profile, we note volatility in selected credit metrics during the last two to three years due to market conditions and its high exposure to power price volatility, as the company does not engage in any power price hedging. Although fiscal year 2020 showed negative operating cash flow and weak financial credit ratios, we expect 2021 to be the opposite, resulting in unusually conservative credit ratios. With our power price assumption and our expectation that the company will have higher investments going forward and maintain its dividend policy, we expect the company to operate with leverage of 2x-3x in the medium term.

Based on the company's high volatility risk, we put more weight on the business risk profile than the financial risk profile when assigning the overall issuer rating, as long as liquidity is adequate. This is also reflected in our positive and negative rating triggers described in the Outlook section.

Ratings & Outlook

Corporate issuer rating BBB/Stable
Senior unsecured rating BBB

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Related Methodologies

European Utility Methodology

Corporate Rating Methodology

Government Related Entities Methodology

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Under our supplementary rating drivers, we make no specific adjustments for financial policy, as this is already reflected in our financial risk profile assessment. We note that the company aims to keep an investment-grade profile, and thus capex plans should always be analysed against this goal before any commitment is made. Should the company make a large investment that increases its financial risk, we understand its policy could be to secure part of its power pricing risk via a hedging arrangement in the future.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that SKL will continue to be a cost-efficient and profitable hydropower generation company that maintains a prudent and conservative financial risk profile that can withstand the expected volatility in power prices. It also assumes the indirect municipality owners will continue to be long-term owners with both the capacity and willingness to support the company if needed.

A positive action is remote as long as business risk is not reduced through measures that reduce the company's high volatility. In this scenario, it could be warranted if discretionary cash flow remained positive over time, resulting in a sustainable improvement in credit metrics. This would be exemplified by a Scope-adjusted debt/EBITDA of around (or below) 2x on a sustained basis.

A negative rating action could be triggered by lower achieved wholesale prices for electricity and larger investment ambitions. This would create a weaker financial risk profile, exemplified by a Scope-adjusted debt/EBITDA of above 3.5x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Profitable, low-cost hydropower generator (positive ESG factor) with relatively high-water reservoir capacity and natural inflow from glacier • Long-term, indirect municipality ownership justifying status as a government-related entity and a one-notch uplift from the stand-alone rating	• High exposure to volatility in power prices for unhedged power production output • Low diversification by segment and geographical pricing market • High dependency on largest power plants

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile through measures that reduce inherent industry risk and the company's high volatility • Including the above, and cash flow used to service debt rather than expansion capex, resulting in sustained Scope-adjusted debt/EBITDA of around (or below) 2x	• More aggressive growth ambitions or sustained, weaker power prices and market conditions • Weaker financial risk profile, exemplified by Scope-adjusted debt/EBITDA of above 3.5x on a sustained basis

Financial overview

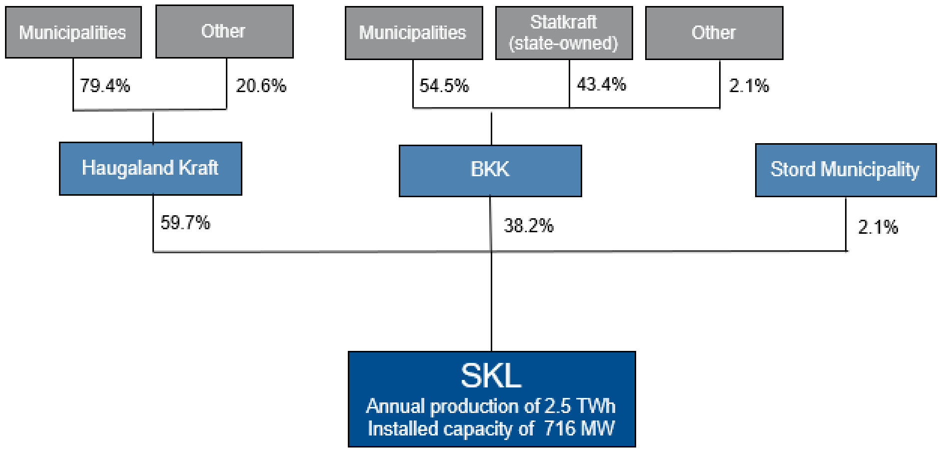
			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	44.6x	5.7x	46.4x	24.0x
SaD/Scope-adjusted EBITDA	1.0x	10.9x	0.5x	2.1x
Scope-adjusted funds from operations/SaD	30%	-14%	205%	-1%
Free operating cash flow/SaD	-27%	-37%	137%	-32%
Scope-adjusted EBITDA in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBIT	597	57	1,132	539
add: depreciation	62	63	62	68
EBITDA	**659**	**120**	**1,194**	**607**
Scope-adjusted funds from operations in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	659	120	1,194	607
less: (net) cash interest as per cash flow statement	-15	-21	-26	-25
less: cash tax paid as per cash flow statement	-461	-283	-33	-607
Other items	12	-1	-2	17
Scope-adjusted funds from operations	**197**	**-185**	**1,133**	**-8**
Scope-adjusted debt in NOK m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	832	1,368	931	1,331
less: cash and cash equivalents	-187	-66	-385	-79
add: pension adjustment	4	8	8	8
add: cash not accessible	-	-	-	-
add: other	-	-	-	-
Scope-adjusted debt	**649**	**1,310**	**553**	**1,260**

Business risk profile

Industry risk profile

SKL is mainly exposed to pure power-generation industry risk, which we consider to be highly cyclical and have medium barriers to entry (details here).

Figure 1: Simplified organisational structure



Source: SKL, Scope

A small power generator in Norway, but with high water reservoir share

With production of about 2.5 TWh, SKL is considered a relatively small power generator in Norway (less than 2% of total production). However, we highlight that size is not overly important when assessing the market position and credit quality of a power utility. This is because the company has high-capacity utilisation and is favourably positioned with its hydropower assets at the front of the merit order system, with a low-cost profile. Large storage capacity and high installed capacity provide the Norwegian hydropower system with significant flexibility in the European context.

For SKL specifically, we note positively that it has a relatively high share of hydro reservoir capacity, which accounts for around 50% of its annual production. Another mitigating factor for SKL in years with low precipitation is that some of its water comes from natural meltwater from the Folgefonna glacier. This has a smoothing effect, enabling the company to maintain higher production during periods with little precipitation.

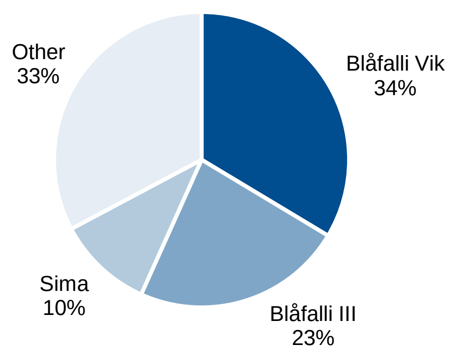
High asset concentration risk and limited geographical diversification

We regard SKL's geographical diversification as limited compared to larger European power producers, but also less favourable than that of some of its local peers. The company is largely concentrated in the western part of southern Norway, and while its power could virtually be sold anywhere within the Nord Pool market, we are also aware of price differentiation that could occur regionally.

SKL's diversification of its power generation portfolio is less than adequate based on the exposure to its largest hydropower plant. SKL's exposure to this plant makes up approximately 30% of the company's annual production, while the three largest plants make up approximately 60%. In sum, SKL has almost 40 partly or wholly owned power plants.

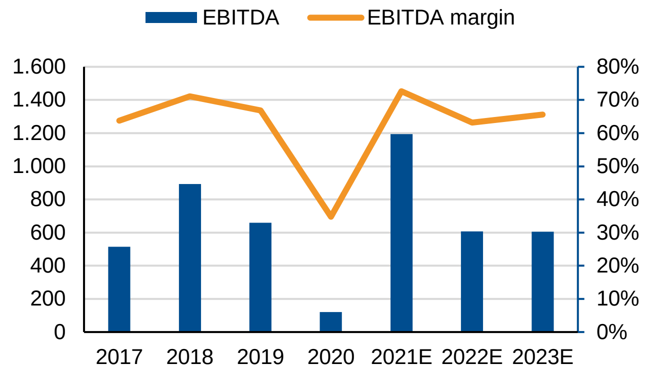
SKL has been seeking out collaboration and strategic alliances lately, as demonstrated by its offshore wind power project (Deep Offshore Wind) and its hydrogen project (Hydrogen Solutions). At present, the latter is a relatively small investment while the wind project is clearly still just a prospect awaiting concession. Although these initiatives could increase diversification over time, they are not incorporated in our future diversification profile, and thus no effect on our current rating assessment

Figure 2: Production dependency on largest plants



Source: SKL, Scope

Figure 3: EBITDA (NOK m, LHS) & margin development



Source: SKL, Scope

Strong but volatile operating profitability

SKL's profitability margins are very high due to its dominant hydropower production share. The company has taken an active decision not to engage in any power price hedging and is not active in trading activity either. As a result, we have paid attention to the fluctuating factors stemming from electricity generation volumes and achievable prices when assessing the profitability volatility of the company. In 2020, the EBITDA margin was negatively affected by historically low power prices in the Nordic region, but the company still managed to report a margin of above 30%. Although this indicates some volatility from the normalised >60% margin we have applied for the company, its profitability exceeds that of many relevant peers and is a positive driver of the company's overall competitive positioning.

Financial risk profile

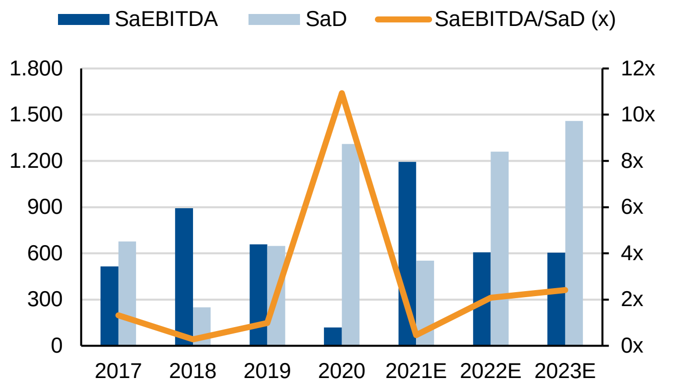
The financial risk profile has experienced significant volatility in selected credit metrics during the last two years due to market conditions and its large exposure to power price volatility. Although last year showed negative operating cash flow and weak financial credit ratios, we expect 2021 metrics to be exceptionally good given the significantly improved market prices achieved this year.

The main drivers behind our long-term forecast and credit ratio expectations are:

- For 2022 and beyond, we have used forward market prices as guidance, expecting achieved prices for SKL to gradually go down towards a more normalised historical price level.
- Total production volume is expected to be slightly below the historical mean in the short term, while we assume normalised annual production output from 2023.
- Lower taxes paid in 2021 (due to the low result in 2020), while taxes paid in 2022 will again be very high, due to the situation this year. Normalisation is expected from 2023 onward.

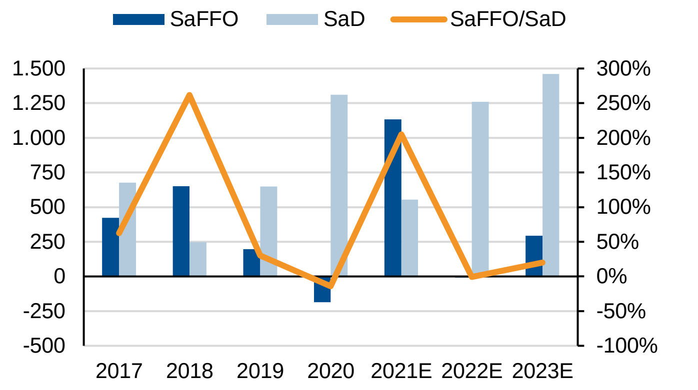
With these assumptions and our expectation that the company will have higher investments going forward while maintaining its dividend policy, we believe the company is likely to operate with leverage of 2x-3x over time in a more normalised power price scenario. However, due to the unhedged position, uncertainty is high.

Figure 4: EBITDA and Scope adjusted debt (NOK m, LHS) and leverage (x, RHS)



Source: SKL, Scope

Figure 5: Funds from operations (FFO) and Scope adjusted debt (in NOK m LHS), and FFO/SaD (%, RHS)



Source: SKL, Scope

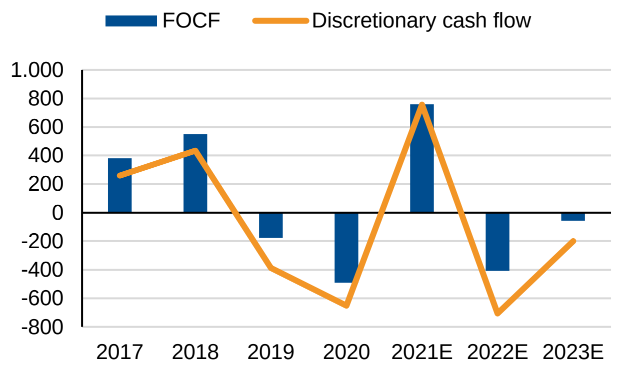
Volatility of credit metrics to be expected

Cash flow volatility is evident for SKL, due to its high exposure to power production and fluctuating market prices. In addition, there is the tax regime, which could make any particular year even more volatile. Thus, we have judged cash flow generation over time and looked at long-term normalised levels, adjusted for volatility risk. What we clearly see is higher volatility risk for SKL compared to companies that have grid business or engage in hedging activity. In our forecast, we expect free operating cash flow to be largely negative from 2022 in the medium term, based on investment plans and more normalised price levels.

Most of the capex expected in the next three to five years is related to various new or expanded hydro production plants, but also some improvements to reservoirs and dams and ordinary maintenance investments. A key project is the one in Etne (NOK 600m, to be completed in 2023), which will double the effect and increase production volume by 10% compared to the company's two old power assets there. We expect annual investment levels to increase by about 40% p.a. on average in the 2021-23 period versus the levels seen in 2019 and 2020. Beyond 2023, we understand that the company still aspires to grow its annual production output, largely by continuing to invest in new facilities. But it could also be open to acquiring smaller power plant portfolios to reach its longer-term target of about 3 TWh of total production.

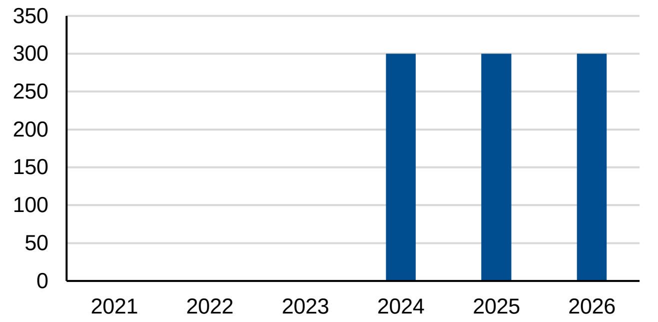
With respect to the numbers behind discretionary cash flow expectations, we assume annual dividends paid to owners at 60% of net income.

Figure 6: Free operating cash flow (FOCF) and discretionary cash flow in NOK m



Source: SKL, Scope

Figure 7: Debt maturity as of Oct 2021, in NOK m



Source: SKL, Scope

Adequate liquidity and mostly long-term financing at the moment

In terms of liquidity, the company has always managed to have backstop credit facilities and cash covering its short-term maturing debt in recent years. Today, the next maturing debt is in 2024 (post the bond repayment in September), and thus funding needs going forward are currently driven more by adding long-term debt to allow for continued organic investment growth.

Supplementary rating drivers

Prudent financial policy

We have made no adjustment for financial policy, as this is already reflected in our financial risk profile assessment. We note that the company aims to keep an investment-grade profile, and thus capex plans should always be analysed against this goal before commitment. Due to the effect that power price volatility has had on the company, it strives to have a strong equity ratio and pursues other internal credit ratio targets to be able to withstand these swings. Should the company make larger investments that increase its financial risk profile, we understand that its intention could be to secure part of its power pricing risk via a hedging arrangement.

Indirect municipality ownership

Although the ownership structure is more complex than direct ownership by a municipality, we view the calculated indirect 70% municipality ownership as a group of owners with the same level of ambition and interest in the company.

Thus, our assessment of indirect majority municipal ownership of SKL is based on potential parent support being determined not by the stand-alone performance or credit quality of BKK or Haugaland Kraft, but by the capacity and willingness of their municipal owners to provide support if needed.

We have used our government-related entities methodology to assign a one-notch uplift to SKL's stand-alone credit rating. The one-notch uplift for ownership is in line with other Scope-rated Norwegian utilities featuring direct or indirect majority or full municipality ownership without explicit guarantees.

Based on the methodology framework, we have assessed both the overall capacity and likelihood of the owner to provide support medium, which includes an evaluation of strategic importance, ease of substitution and default implications.

Governance and structure

We see the structure and setup of SKL as evolving, given the Haugaland Kraft and BKK ownership. In addition, considering the consolidation in the Norwegian utility sector, going for larger units, we see some transactional risk in the long term, but we have not factored this in at this point.

We also acknowledge a well-integrated ESG framework and ambitions that include publishing green financing reports.

Long-term and short-term debt ratings

The BBB senior unsecured debt rating, which is in line with the issuer rating, is based on the company's standard bond documentation, which includes a pari passu clause and a negative pledge. Senior unsecured bonds are issued at the level of Sunnhordland Kraftlag AS.

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