Eidsiva Energi AS
Norway, Utilities

SCOPE BBB- STABLE

Corporate profile

Eidsiva Energi AS (Eidsiva) is a Norwegian company engaging in utility-related operations primarily in the Hedmark and Oppland counties. It is a fully vertically integrated utility company with activities in power production, power distribution and retail sales. The company also provides broadband services in the region. Eidsiva has an annual average hydropower production of about 3.4TWh and around 400GWh of district heating production. As part of its distribution business, the company builds, operates and renews a power grid (air lines and ground cables) with a range of over 22,000 kilometres. The group is owned by 27 municipalities and two county municipalities, Oppland and Hedmark.

Key metrics

			Scope estimates	
Scope credit ratios	2015	2016	2017F	2018F
EBITDA/interest cover (x)	3.8x	4.0x	4.0x	3.9x
SaD (excl. sub. loan) /EBITDA	5.6x	5.8x	6.2x	6.1x
Scope-adjusted FFO/SaD	10.5 %	8.6 %	8.9 %	8.7 %
FOCF/SaD	neg.	neg.	neg.	neg.

neg. = negative number

Rating rationale

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

Eidsiva's business risk profile benefits from the relatively large share of protected infrastructure business across its power distribution grid, coupled with a growing portion of fibre business within its broadband activities. Moreover, Scope recognises the improved profitability and efficiency which the company has developed in its bioenergy business, which now makes a meaningful contribution to overall EBITDA. The company's fully integrated utility value chain is also supportive of overall business risk which, combined with its broadband business, creates a more stable and less volatile profitability pattern. Negative business risk assessment factors include Eidsiva's limited geographical outreach for some business segments outside its local counties in Norway.

With regard to Eidsiva's financial risk profile, Scope notes the highly leveraged situation in which the company is currently operating. Even including the assumed conversion of the subordinated debt to equity, leverage is expected to remain high in the medium term (until 2020) due to extensive grid investment plans. The present situation results in negative free cash flow and the need for external financing. Even so, Scope assesses liquidity as more than sufficient, backed by the company's undrawn credit lines, as well as its track record of good access to both bank debt and debt capital markets.

Scope highlights the fact that Eidsiva's issuer credit rating of BBB- is not based on any explicit support or guarantees from its owners. Nevertheless, Scope regards Eidsiva's municipality ownership structure as strongly supportive of overall credit quality, leading to a one-notch uplift from the stand-alone credit rating of BB+.

Ratings & Outlook

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

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Outlook

The Stable Outlook reflects Scope's expectation that Eidsiva will continue to be a diversified utility, with operations in power production, distribution and sales, coupled with broadband-related businesses. Scope anticipates that the infrastructure business segments will continue to represent a meaningful part of the company's EBITDA but that credit metrics will be somewhat weaker in the short term, driven by negative free cash flow after investments. Nevertheless, Scope assumes that liquidity will remain more than sufficient based on new financing, which has already been announced. Scope also expects that the company will continue to enjoy good access to both the bank and bond market, and that operating profitability and funds from operations (FFO) will improve in the short to medium term. The rating Outlook reflects Scope's assumption of continued majority ownership by the municipalities.

A rating upgrade could be warranted if the company converted its shareholder loan to equity, reported positive free cash flow and conducted asset sales, all of which together would reduce overall leverage, interest payments and the net investment in the company. This would result in a Scope-adjusted leverage ratio below 5x and Scope-adjusted interest cover above 5.5x on a sustainable basis.

A negative rating action could be trigged if the company participated in a debt-financed structural transaction that proved detrimental to its business risk profile or if its financial risk profile was weakened due to sustainably lower wholesale prices.

Rating drivers

Positive rating drivers	Negative rating drivers
• Diversified business model, with large share of monopolistic power distribution, as well as profitable broadband and bioenergy business • Long-term, supportive and committed municipality owners • Environmentally-friendly hydropower production, with favourable placing in the merit order system	• Ongoing sizeable investment phase, resulting in negative free cash flow and external funding requirements • Somewhat aggressive financial credit ratios, even when adjusting for the subordinated owner loan • Limited geographical outreach for businesses outside its main counties

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Conversion of shareholder loan to equity, coupled with positive free cash flow (supported by asset sales) • Scope-adjusted leverage ratio below 5x and Scope-adjusted interest cover above 5.5x on a sustainable basis	• Debt financed structural transaction altering the business risk profile • Sustainably lower wholesale prices placing severe pressure on financial risk profile

Financial overview

			Scope estimates	
Scope credit ratios	**2015**	**2016**	**2017F**	**2018F**
EBITDA/interest cover (x)	3.8x	4.0x	4.0x	3.9x
SaD/EBITDA	6.9x	7.0x	7.4x	7.2x
SCOPE-adjusted debt (excl. shareholder loan)/EBITDA	5.6x	5.8x	6.2x	6.1x
Scope-adjusted FFO/SaD	10.5 %	8.6 %	8.9 %	8.7 %
Scope-adjusted EBITDA in NOK m	**2015**	**2016**	**2017F**	**2018F**
EBITDA	1,136	1,245	1,259	1,342
Operating lease payment in respective year	32	35	36	37
Scope-adjusted EBITDA	1,168	1,280	1,295	1,379
Scope funds from operations in NOK m	**2015**	**2016**	**2017F**	**2018F**
EBITDA	1,136	1,245	1,259	1,342
less: (net) cash interest as per cash flow statement	-330	-358	-313	-339
less: cash tax paid as per cash flow statement	-106	-79	-245	-216
add: depreciation component operating leases	20	22	22	23
Other non-cash related adjustments	125	-59	128	52
Scope funds from operations	845	771	850	862
Scope-adjusted debt in NOK m	**2015**	**2016**	**2017F**	**2018F**
Reported gross debt	6,241	6,999	7,810	8,270
Cash, cash equivalents	-328	-122	-398	-453
Cash not accessible	80	53	50	50
Pension adjustment	304	270	262	254
Operating lease obligation	247	270	278	286
Subordinated owner loan	1,519	1,519	1,519	1,519
Scope-adjusted debt	8,063	8,989	9,521	9,925

Business risk profile

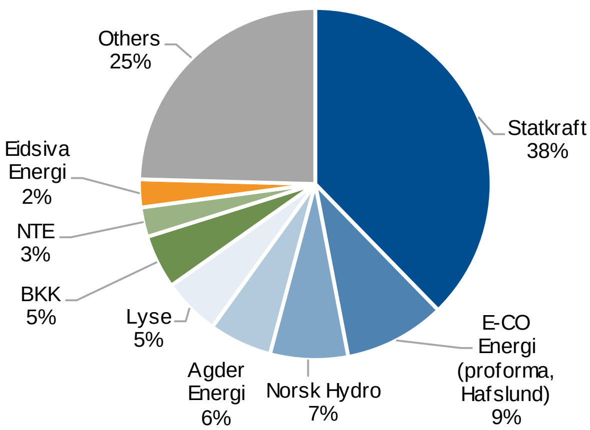
Scope's analysis of Eidsiva's business risk profile is split into industry risk and competitive position, whereby the latter includes our assessment of market position, diversification and operating profitability/efficiency.

Industry risk

Blended industry risks of BBB+

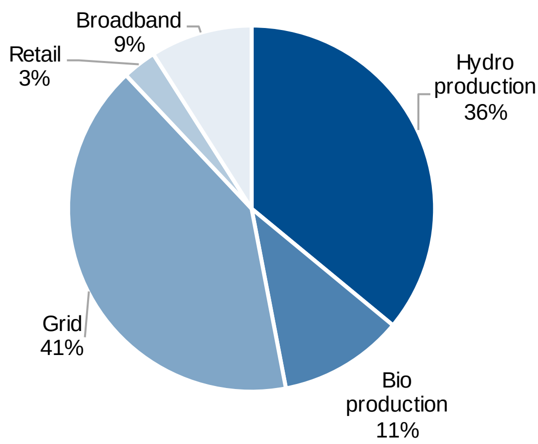
In accordance with Scope's rating methodology for utilities, we assess each of the company segments separately, taking their different characteristics into account. Using a normalised EBITDA split, Eidsiva has a relatively conservative weighted average industry rating based on its high exposure to the regulated distribution business (41%), coupled with a profitable broadband service (9%). Scope considers both of these industries to have low cyclicality, while the protected grid business also has high entry barriers. With power sales EBITDA representing only 3% of the normalised EBITDA contribution, the remaining exposure for Eidsiva is power generation (47%). The latter exhibits highly cyclical features, but Scope notes that the company's less volatile bioenergy business now contributes a meaningful part of the company's power generation EBITDA.

Figure 1: Norway's main hydro generation companies



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

Figure 2: Segment split based on normalised EBITDA



Source: Eidsiva, Scope

Competitive position

Scope's overall assessment of Eidsiva's competitive position is based on the sum of its parts

Given Eidsiva's diversified business model with exposure to different infrastructure segments, Scope's assesses the company's competitive positioning based on the sum of its parts.

Scope regards Eidsiva's competitive position in its individual business segments to be supported by:

- Full integration within the energy utility's value chain, coupled with positive diversification effects from its broadband services
- A relatively large EBITDA share of protected monopoly business through the operation of its distribution grids, as well as a strong penetration rate for these customers in its retail sale business
- A strong, but still small, standing in the power generation market (eighth in Norway, providing 3% of electricity consumption) with a favourable position in the merit order system
- Some mitigation of pricing and volume risk in power production through hedging activities

- A large share of private customers in Innlandskraft, representing approx. 90% of customers and approx. 70% of volume

Nevertheless, Eidsiva's competitive position is hampered by:

- Full merchant risks for its outright power production volumes and somewhat lower EBITDA margins than its best peers
- Limited geographical outreach within Norway and small market shares in the more competitive broadband business

Eighth largest hydropower producer in Norway

Eidsiva owns and operates 46 wholly or partially-owned hydropower plants with a net annual production share of about 3.4 TWh, making it the eighth largest producer in Norway. Including the 10 district heating plants and the power plants for which the company has operational responsibilities, gross annual production is almost 8 TWh. Scope notes that Eidsiva's hydropower plants hold a strong position within the Nordic market's merit order system. In addition, the company is not highly dependent on any particular asset, with its three largest hydropower plants making up less than 23% of annual power generation.

Strong and efficient grid operations

Eidsiva's market position is also supported by its high exposure to the operation of power grids, through which it supplies electricity to more than 150,000 customers. In power sales, ownership cooperation with Gubrandsdal Energi has increased Innlandskraft's market position to number three in Norway. Scope notes that Eidsiva plans to grow the number of customers in this business further.

Small fibre market share and limited geographical diversification

Scope regards Eidsiva's limited geographical diversification, with activities largely confined to two regional areas in the Norwegian domestic market, as a significant credit weakness. Nevertheless, Scope does not place too much emphasis on Eidsiva's lack of geographical diversification given that this is tempered by the company's monopolistic position in grid operations and secured utilisation of power generation assets. However, Scope considers Eidsiva's low market positions and geographical diversification in its broadband/fibre business (approx. 3% of market share on the national level) to be more important, given the expected increase in price competition in this environment.

Volatility reduced by some volume hedging and diversified business model

The adjusted average underlying EBITDA margin for Eidsiva over the last five years has been around 30%. Scope regards the company's overall profitability profile as relatively stable, but notes the greater volatility of profitability stemming from electricity generation volumes and achievable prices. Despite this, overall volatility is seen as adequate due to improving telecom-related profitability, as well as bioenergy production. We also note the company's access to hydro reservoir capacity (around 40% of its average electricity production), and that the company is engaged in some long-term hedging of price and volume risk in its hydropower production with industrial clients. At the moment, Eidsiva has a long-term contract (until 2024) with Borregaard to deliver 510 GWh p.a. (16% of its production), and from 2021 it will add on 300 GWh for delivery to Norsk Hydro (until 2030).

Profitability margin affected by operational service agreements

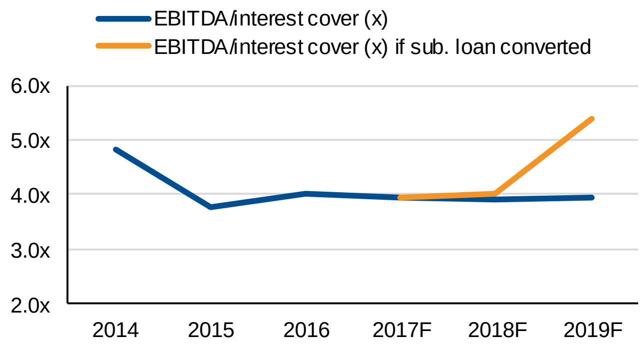
When analysing profitability and efficiency, Scope observed that almost 50% of hydropower revenues are related to operational service agreements for power plants outside Eidsiva's ownership, for which the company recognises revenues at actual cost. This artificially lowers Eidsiva's EBITDA margin in its hydro business, which we take into consideration.

Financial risk profile

Credit metrics have deteriorated lately

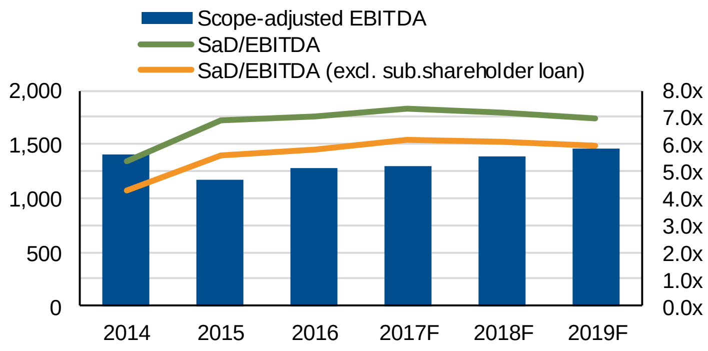
Eidsiva's key credit metrics have deteriorated in recent years driven by negative free cash flow. As a result, selected financial metrics are currently falling within the non-investment grade financial risk brackets. However, the assumed conversion of the subordinated shareholder loan to equity should improve credit metrics in 2019. Moreover, declining net investment requirements will also enhance credit metrics starting next year. Nevertheless, even if we exclude the subordinated shareholder loan from the leverage calculation today, we are likely to see a leverage ratio above 6x for the 2017-2019 period. Although Scope accepts higher leverage ratios for companies with high exposure to a regulated distribution business, we still assess Eidsiva's financial risk profile as somewhat aggressive. An FFO/SaD below 10% is also seen as low compared to the company's better-rated peers, coupled with a Scope-adjusted interest cover ratio averaging around 4x.

Figure 3: EBITDA net interest coverage development



Source: Scope, Eidsiva

Figure 4: SaD/EBITDA (with/without sub. loan)



Source: Scope, Eidsiva

Underlying FFO is stable

With respect to the company's EBITDA profitability and cash flow, we deem operational profitability to be relatively stable, supported by Eidsiva's diversified business model. FFO is expected to stay above NOK 0.8bn in the medium term, but as Eidsiva is currently undergoing a period of investment, we believe that the company's free cash flow will remain negative until 2020. The capital expenditure is mainly attributable to grid operations, representing around 65% recently, with power production capex making up around 20%, and broadband and other businesses accounting for the remainder.

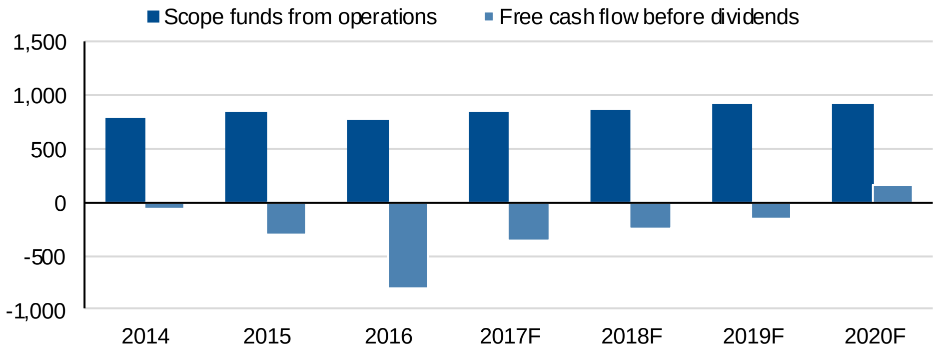
Negative free cash flow due to period of high investment in the grid

Scope projects that the high investment requirements and negative free cash flow projections will, to some degree, be mitigated by planned asset sales. These planned non-core assets sales in 2018 and 2019 (shares in Moelven industrier and a seller's credit with EQT) are understood to be a result of the management's intention to reduce net investment and limit the negative impact on the balance sheet, which Scope considers positive.

Scope-adjusted debt estimated to increase by NOK 1bn in the next two years

As a result of negative free cash flow, the company has been in need of external financing lately. At the end of Q3 2017, Scope-adjusted debt (SaD) totalled approximately NOK 7.7bn (excluding the NOK 1.5bn subordinated shareholder loan). In addition to the shareholder loan, SaD has been adjusted for operating leases and pension liabilities in the range of approximately NOK 0.5bn together. In the period up until 2019, Scope projects that the company will increase its SaD by approximately NOK 1bn.

Figure 5: Cash flow development

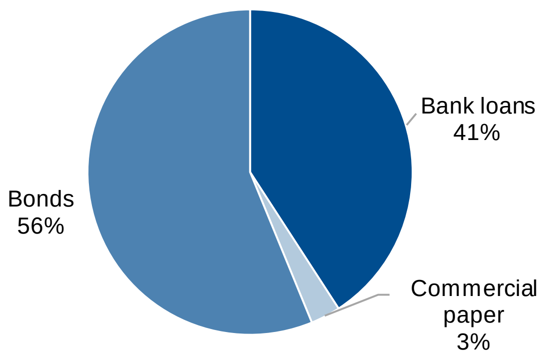


Source: Scope

Sufficient liquidity, with S-2 short-term rating

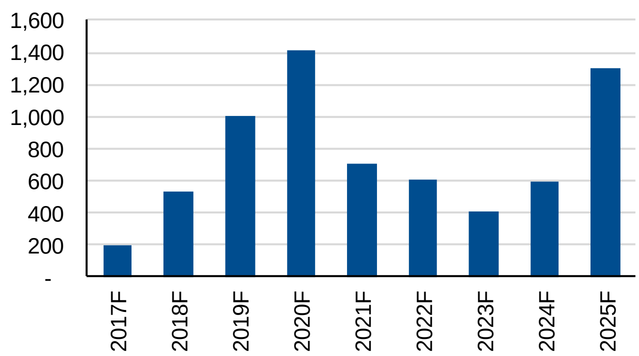
Eidsiva enjoys 'better than adequate' liquidity, based on Scope Ratings' methodology criteria, and has been assigned an S-2 short-term rating. We project liquidity to remain sufficient based on new financing, which has already been announced, and the expectation that access to both the bank and bond market will remain good. At the end of Q3 2017, cash and undrawn committed credit lines totalled more than NOK 1.35bn, which exceeded short-term debt at that point.

Figure 6: Funding structure Q3 2017



Source: Eidsiva, Scope

Figure 7: External debt maturity profile, as of Q3 2017



Source: Eidsiva, Scope

In our projection, we have assumed a slightly declining dividend pay-out, based on the approval given by the owner in 2016 to reducing the dividend in the 2017-2019 period. However, we note the uncertainty surrounding dividend pay-outs from 2019, if the owners agree to convert the subordinated loan to equity.

Subordinated shareholder loan will be converted to equity

At the latest Eidsiva owner meeting in November 2017 the proposal made by the company's Board of Directors to convert the subordinated loan back to equity was presented and discussed. Based on the sizeable investment plans and new less attractive tax-deductible rules for this loan going forward, the owners agreed to initiate the process, with the ambition of confirming and closing before YE 2018. Scope favours the replacement of the high fixed-interest payment on this loan (approx. 7%) with more discretionary dividend payments in the future. The effect of this conversion on selected pro forma credit ratios is positive, with FFO/SaD improving from a current level of approximately 9% to almost 12%, while interest cover would be enhanced from the 4x area to around 5.5x.

Supplementary key rating drivers

Focus on securing favourable financing

In discussions with Eidsiva's management, Scope was given to understand that the company's financial strategy is focused on maintaining credit metrics at levels which do not jeopardise its ability to secure favourable funding. The approval obtained from its owners in 2016 to reduce dividends and the ongoing process to convert the shareholder loan to equity are two examples of this strategy.

Even though Eidsiva does not have a single majority shareholder, Scope considers its group of municipal shareholders as equivalent to one majority shareholder. None of the shareholders have sold shares since the establishment of the company in 2004, and their position as municipalities in the region makes them strategic owners with long-term interests. The shareholder agreement contains regulation of a maximum potential private ownership of 33%, from which we also take comfort. This clause was included in the shareholder agreement in order to provide the company with the potential to grow through a merger with a partly privately-owned company.

Municipality ownership provides one-notch uplift from standalone rating

Scope emphasises the fact that the Eidsiva credit rating is not based on explicit support or guarantees from its municipal owners. While the company is in a good position to avoid both a liquidity shortfall due to operational underperformance, or refinancing problems, given the option to sell assets such as hydropower plants quickly, Scope notes the strong probability that the municipalities would provide financial support in the theoretical event of financial distress. We deem the ability and willingness to support the company as very high, given Eidsiva's importance for municipalities in the region.

As a result of the strong rating on the Norwegian state (rated AAA by Scope Ratings) and its municipalities, we consider Eidsiva's ownership structure as supportive for the credit quality of Eidsiva. We therefore incorporate a one-notch uplift to the BB+ standalone rating for Eidsiva, resulting in an issuer rating of BBB-.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.
The rating analysis has been prepared by Henrik Blymke, Managing Director. Responsible for approving the rating: Olaf Tölke, Managing Director
The rating was first assigned by Scope on 08.12.2017. / The rating was last updated on 08.12.2017.

Methodology

The methodologies used for this ratings and/or rating outlooks are Rating Methodology Corporate Ratings 2017 Jan & Rating Methodology European Utilities 2017 Jan. Available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Stress testing & cash flow analysis

No stress testing was performed. Scope performed its standard cash flow forecasting for the company under review.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources. Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Potential conflicts

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