1 April 2022 Corporates

Lyse AS
Norway, Utilities

SCOPE BBB+ STABLE

Corporate profile

Lyse AS is a Norwegian utility company, fully owned by a group of 14 municipalities in south-western Norway. The company operates in three business areas: energy production, power grids and telecommunications. Lyse's hydropower assets have generated a mean yearly output of around 6.1TWh over the past 10 years. This increased to an annual power production capacity of 10TWh in 2021, following a transaction with Hydro's RSK assets. Lyse Kraft DA is 74.4% owned by Lyse, 25.6% owned by Hydro and is the third largest hydropower producer in Norway. Within its monopolistic grid segment, Lyse operates and maintains the regional and district electricity grid and has over 160,000 customers. In telecoms, Lyse has a long history of fibre-optic cables for high-speed digital services. Today, Lyse provides network and content services to around 784,000 customers across Norway and Denmark via different brands and partnerships (i.e. Altibox). Through its most recent acquisition of Ice, the company has gained access to 415,000 mobile phone and 85,000 mobile broadband customers.

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
EBITDA/interest cover (x)	6.8x	19.8x	11.7x	9.2x
Scope-adjusted debt (SaD)/EBITDA	4.9x	1.6x	3.4x	3.5x
Scope-adjusted funds from operations/SaD	13%	48%	13%	20%
Free operating cash flow/SaD	-10.2%	25.1%	-7.5%	1.5%

Rating rationale

The affirmation of Lyse's issuer rating (BBB+) is driven by the company's diversified business model, high power prices, the impact of the acquisition of Ice on its financial risk profile and the unchanged one-notch uplift granted for the municipality ownership.

Over time, Lyse has seen an increasing share of its group EBITDA generated by a combination of robust infrastructure segments, such as monopolistic power distribution and fibre-optic television and broadband services, which helped to better withstand low energy prices in 2020. In 2021, its unregulated energy generation capacity increased to around 10TW from 7TW thanks to the establishment of Lyse Kraft DA in 2020, which includes Hydro Energi AS power stations (nine out of the group's 33 plants). The increased capacity helped Lyse's credit metrics in 2021 thanks to strongly increasing energy prices. The expectation of further rising energy prices has, however, also tilted its industry risk (BBB) further towards this volatile segment.

In September 2021, Lyse (via Altibox) acquired its first 5G licences in a tender, marking its first foray into the mobile business. Lyse intends to expand its reach within wireless broadband to customers who are not financially viable for connecting to its fibre network. The company also announced the acquisition of Ice, Norway's third largest telecoms provider, in March 2022. Lyse will therefore become a complete provider of telecoms services in Norway, extending its fibre broadband business to mobile telecommunications. The acquisition will be settled through a cash consideration of NOK 3bn to Ice, financed using available liquidity at Lyse, while Lyse will also take on

Ratings & Outlook

Corporate ratings	BBB+/Stable
Short-term debt rating	S-2
Senior unsecured debt rating	BBB+

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Related Methodologies

Corporate Rating Methodology, February 2021

European Utilities Rating Methodology, March 2022

Rating Methodology Government Related Entities, May 2022

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Bloomberg: RESP SCOP

NOK 2.8bn of outstanding bond debt from Ice. Scope expects this transaction to strengthen Lyse's telecoms segment over time and to potentially reap diversification benefits, while profitability will be somewhat stunted in the short term. The transaction has larger effects on the financial risk profile than on the business risk profile.

Lyse's 2021 financial performance and credit metrics greatly benefited from the strong increase in energy prices throughout the year, brought along by a combination of factors. Cold weather in early 2021 led to a surge in power demand in Norway, which depleted water reservoirs. The following summer was dry and reservoir levels remained low, thereby constraining hydropower capacity. Milder-than-usual winds also led to low wind power production. Finally, a rise in gas and CO2 prices in autumn 2021 drove up overall energy prices both in Norway and in Europe more generally towards the end of 2021. Prices have increased even further due to the cold weather in early 2022 and the war in Ukraine. Given the high energy prices, Lyse produced above capacity in 2021 at 10.4TWh, resulting in the depletion of water reservoirs in a dry year. Scope expects energy production in 2022 to be well below 2021 levels at only around 8.1TWh, with a slight recovery to 8.5TWh in 2023/24. Leverage as measured by Scope-adjusted debt/EBITDA came in very strong at 1.6x for 2021, after a weak 2020 at 4.9x, demonstrating the high share of unregulated power generation resulting in volatility. Due to the acquisition of Ice and a large capex programme across segments, estimated by Scope to be NOK 4.8bn in total, Scope expects Lyse's gross interest-bearing debt to increase to NOK 22.6bn in 2022. In addition, the company will take over NOK 2.3bn of leasing debt from Ice. This will increase leverage to 3.4x in 2022, expected to remain between 3x-4x in the years to come. Interest coverage remains strong. Due to the significant capex programme in its existing telecoms segment, the acquisition of Ice and elevated grid investments in the coming years, Scope expects cash flow coverage as measured by free operating cash flow(FOCF)/Scope-adjusted debt to be negative in 2022 and to turn just about positive in 2023.

Within the supplementary rating drivers, Scope continues to use the bottom-up approach within Scope's Government Related Entity Methodology to analyse Lyse's parent support. The one-notch uplift assigned for municipality ownership has not changed. The 14 municipality owners are considered as one group, with a long-term, supportive and committed ownership and a predictable dividend policy.

Lyse has started implementing routines and processes to measure and report the various factors included in EU's new taxonomy regulations, which the company intends to include in its reports, starting with the annual report 2022. While this is a positive development, it has a neutral impact on the credit as it will be mandatory for all listed companies.

Outlook and rating change drivers

The Stable Outlook reflects Scope's expectation that Lyse will maintain its diversified business model (energy, grids and telecoms) and strong liquidity, fully covering both short-term debt maturities and the current mandatory investment programme. It also assumes that the acquisition of Ice will go through as planned and take its main credit metrics back to the expected range in 2022, after being above it in 2020 and below it in 2021, as measured by Scope-adjusted leverage returning to the 3x-4x range in the short to medium term. The Outlook also reflects the expectation that Lyse's ownership structure will remain unchanged.

A positive rating action could be warranted if cash flow proved higher than Scope's estimates due to consistently higher power prices or lower capex, which would translate into sustainable positive free operating cash flow, deleveraging, and an improved financial risk profile exemplified by a Scope-adjusted leverage of below 3x on a sustained basis.

A negative rating action is possible if Lyse's financial risk profile weakened due to lower wholesale prices or debt-financed transactions or investments, resulting in leverage of over 4x 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 • Long-term, supportive and committed municipality owners (a government-related entity) justifying a one-notch uplift	• Telecoms business in a relatively large investment phase and expanding through Ice, which puts pressure on FOCF generation • Volatility of achievable prices in its power generation segment • Limited diversification by geographical pricing markets

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved credit metrics through reduced investments, asset disposals and positive FOCF • Scope-adjusted debt (SaD)/EBITDA of below 3x on a sustained basis	• Large debt-financed acquisition of other businesses or significantly lower prices, resulting in a weakened financial risk profile (SaD/EBITDA of above 4x) on a sustained basis • Loss of its government-related entity status

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
EBITDA/interest cover (x)	6.8x	19.8x	11.7x	9.2x
SaD/EBITDA*	4.9x	1.6x	3.4x	3.5x
Scope-adjusted funds from operations/SaD	13%	48%	13%	20%
FOCF/SaD	-10.2%	25.1%	-7.5%	1.5%
Scope-adjusted EBITDA in NOK[1] m	**2020**	**2021**	**2022E**	**2023E**
EBITDA	2,853	8,751	8,064	7,762
Less: Hydro share	0	-1,150	-1,049	-837
Scope-adjusted EBITDA*	2,853	7,601	7,015	6,926
Scope-adjusted funds from operations in NOK[1] m	**2020**	**2021**	**2022E**	**2023E**
EBITDA	2,853	8,751	8,064	7,762
less: (net) cash interest as per cash flow statement	-430	-379	-658	-755
less: cash tax paid as per cash flow statement	-652	-368	-3,349	-1,312
add: depreciation component, operating leases	0	0	-58	-115
Less: Hydro share	0	-1,150	-1,049	-837
Other non-cash items	40	-941	0	0
Scope-adjusted funds from operations	1,810	5,912	2,951	4,743
Scope-adjusted debt in NOK[1] m	**2020**	**2021**	**2022E**	**2023E**
Reported gross financial debt	17,924	17,933	22,599	22,711
less: cash and cash equivalents	-4,106	-6,466	-1,753	-1,272
add: cash not accessible	97	694	694	694
add: pension adjustment	104	105	105	105
add: operating lease obligations	0	0	2,300	2,300
Other	18	23	23	23
SaD	14,036	12,288	23,967	24,559

*as EBITDA include the fully consolidated Lyse Kraft DA, the SaD/EBITDA (excluding the estimated minority portion of Hydro) is higher
1. Editorial note: The currency was amended on 21 April 2022. In the original publication from 1 April 2022 the currency was EUR.

Business risk profile: BBB+

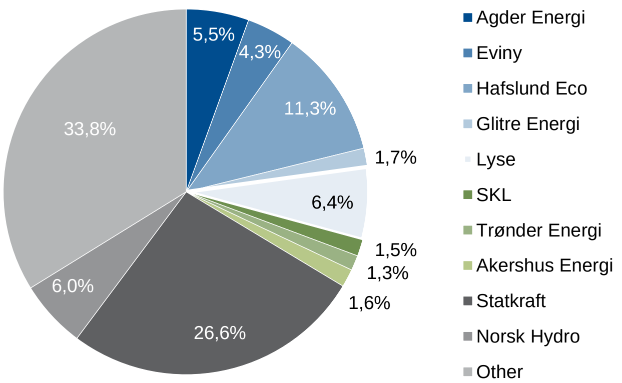
Industry risk: BBB

Lyse's three segments expose it to different industry fundamentals, which we blend by normalised EBITDA contributions. We apply a mostly forward-looking approach on its segment split and consider 50% of EBITDA from unregulated power generation (industry risk: BB), 10% from regulated grid operations (AA) and 40% from telecoms (A). This results in a blended industry risk of BBB.

Lyse's normalised electricity generation including the 10TWh from Hydro is relatively small compared international power generators. Nevertheless, the company is considered a major power generator in Norway and the Nordpool market: its annual production from hydropower plants makes it the country's third largest electricity generator (Figure 1), with about 6.4% of national electricity production. More importantly than their size, the company's hydro plants are favourably placed in the Nordic market's merit order system, thanks to the comparatively low marginal costs of electricity generation. Lyse's access to a water reservoir, which at 100% capacity equates to 6.8TWh or two-thirds of the company's annual production, is viewed as credit positive, as it ensures flexibility on power generation and enables the company to optimise its power sales, particularly during peak-load times when prices are more favourable. These reservoir capacities were utilised heavily during 2021, a dry year, when prices became very favourable towards the end of the year – on the flip-side this translated into a depletion of reservoirs down to 42% of capacity at year-end 2021, reducing the potential power production in 2022.

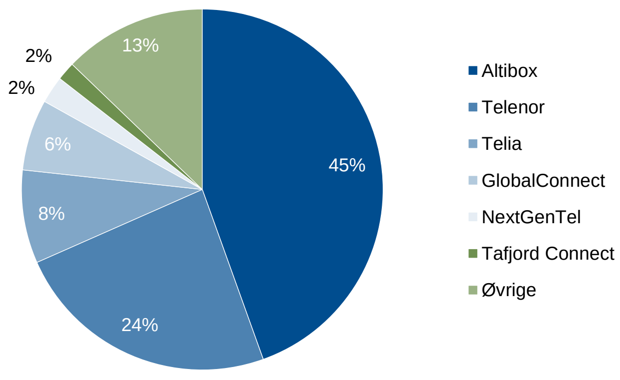
Overall market position is enhanced by the protected and robust cash flow contribution from power distribution (electricity, gas and heat) in south-western Norway, given Lyse's monopolistic position for such services. The tariff-setting system is well established and reliable in Norway. With such a supportive regulatory framework, we consider the structural aspect of Lyse's service territory as stable overall.

Figure 1: Lyse's market position in power generation (electricity) in Norway (% of total in 2021)



Source: companies, Scope estimates

Figure 2: Lyse's market share in Norwegian fibre broadband



Source: Norwegian Communications Authority, Lyse, Scope

Large and still expanding market shares

Within the telecoms/broadband business, the Lyse group and its partners are together the largest supplier of fibre broadband in Norway. The group covers around 45% of the market, with around 784,000 customers. Lyse also offers television services through fibre technology. Thanks to the acquisition of 5G licences in a tender in autumn 2021, Lyse became a provider of fixed wireless access, with the intention of expanding its reach to customers who are not financially viable to link to its fibre network. The March 2022 acquisition of Ice extends the telecoms segments to become a complete telecoms provider including mobile telecommunications.

Lyse's lack of geographical outreach in its unregulated utility business is partly offset by the protection provided by regulated activities in power distribution and by the higher diversification in the telecoms business. In 2020 Lyse entered into an agreement with Hydro to merge part of their hydropower production in southern Norway with a joint company (Lyse Kraft DA). This increased Lyse's power plants from 24 to 33 and reduced potential vulnerabilities to specific power plants. The recent connection of Norway's transmission network to European interconnectors (UK and Europe) broadens Lyse's international reach through selling its generated power at potentially more favourable prices.

Lyse's profitability has historically shown relatively stable EBITDA margins above 40%. Declining energy prices in 2020 put overall margins under pressure, demonstrating the vulnerability of Lyse's unregulated power generation to price volatility, somewhat balanced by more stable margins in grid and telecoms. The strong increase in power prices in 2021 has reversed the pressure (unregulated power at 49% EBITDA margin) and our expectation of elevated power prices going forward supports overall margins above 40%, but we highlight the volatility element in Lyse's large unregulated power segment.

Financial risk profile: BBB-

Financial risk profile affected by Ice acquisition

Lyse's issuer rating remains somewhat constrained by its financial risk profile, assessed at BBB-, which we expect will be impacted by the acquisition of Ice. The acquisition will be settled through a cash consideration of NOK 3bn to Ice, financed using available liquidity at Lyse, while Lyse will also take on NOK 2.8bn of outstanding bond debt from Ice and NOK 2.3bn of leasing liabilities.

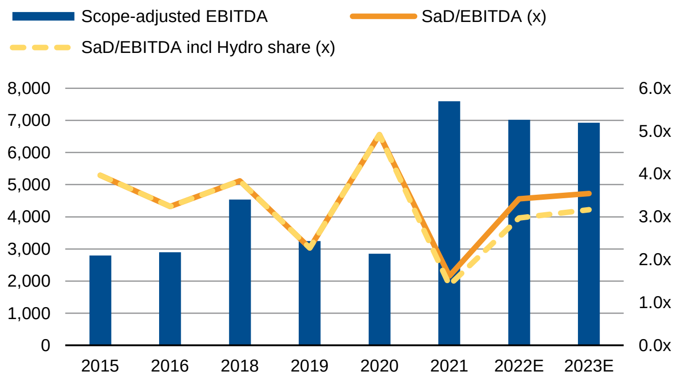
The above financing effects in addition to a significant Scope estimated capex programme of NOK 4.8bn results in our forecast of Scope-adjusted debt increasing to 23.4bn at year-end 2022, up from 11.7bn at year-end 2021.

Cold weather in early 2021 led to a surge in power demand in Norway, which depleted water reservoirs. The following summer was dry and reservoir levels remained low, thereby constraining hydropower capacity. Milder-than-usual winds also led to low wind power production. Finally, a rise in gas and CO2 prices in autumn 2021 drove up overall energy prices both in Norway and in Europe more generally towards the end of 2021. This translated into record revenue for its unregulated power generation segment and a Scope-adjusted EBITDA of NOK 7.6bn for 2021. The latter is adjusted for Hydro's share of EBITDA at NOK 1.15bn. The power price curve has increased even further in the first quarter of 2022 due to a cold winter and the war in Ukraine, which is reflected in our forecasts for 2022 and beyond. Lower production volumes of 8.1TWh in 2022 (versus 10.4TWh in 2021) due to depleted reservoirs that need to fill up are expected to mitigate the elevated prices. In addition to a strong EBITDA contribution from power generation, we also foresee an increased grid and telecoms contribution. The latter should benefit from a positive EBITDA contribution from Ice as early as 2022. These effects result in an estimated EBITDA of NOK 7.0bn for 2022.

Leverage between 3-4x expected

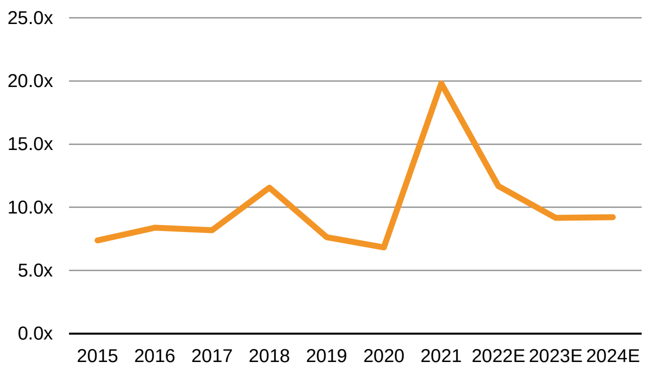
Leverage as measured by Scope-adjusted SaD/EBITDA has been above Scope's outlook expectation of 3x-4x in 2020 (4.9x) and well below in 2021 (1.6x), which demonstrates the volatility of power prices feeding through to Lyse's financial risk profile – something that is viewed as a credit constraint. Factoring in the expected effects of the Ice transaction on both debt and EBITDA, we forecast a leverage of 3.4x in 2022 and within our outlook guidance in the coming years.

Figure 3: Leverage



Source: Scope estimates

Figure 4: Interest cover



Source: Scope

Debt protection remains strong

Debt protection as measured by EBITDA interest cover remains strong despite the increased debt levels as a result of the Ice transaction forecasted at 11.8x at year-end 2022.

Capex coverage remains volatile. While 2021 cash generation resulted in a very strong FOCF of NOK 3.1bn despite a sizeable capex spending of NOK 2.9bn, we foresee a return to negative FOCF in 2022. Lyse's elevated capex in the grid segment (mostly in the local network) as well as in fibre telecoms is additionally burdened by planned capex for the new Ice segment, taking overall Scope estimated capex to NOK 4.8bn. We foresee elevated capex requirements in 2023 and thereafter but given strong expected cash flow from its three segments, we nevertheless forecast a return to positive FOCF.

Liquidity remains strong with cash sources exceeding short-term debt in 2022 by 4.3x.

Supplementary rating drivers

One notch uplift for municipality ownership

We continue to use our bottom-up approach to analyse Lyse's parent support and the one-notch uplift assigned for municipality ownership is unchanged. Although we noted last year that a reduction of municipality ownership in Lyse's production occurred as a consequence of the Hydro acquisition, it does not trigger any change in the overall supplementary government-related entity rating adjustment for Lyse, still 100% owned by 14 municipalities. The owners are seen as one group, with a long-term, supportive and committed ownership. We make no adjustment for financial policy. However, we note positively that management targets a minimum credit rating of BBB+ and is thus aware of the credit ratios it needs to maintain. In addition, management's liquidity strategy includes the stated ambition that cash should cover operational and investment activities as well as debt maturities and dividends in the next six months.

Long-term and short-term debt ratings

The BBB+ senior unsecured debt rating is in line with the issuer rating. We have also affirmed the S-2 short-term rating, still reflecting sufficient short-term debt coverage, and good access to both bank loans and debt markets.

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