5 June 2024 Corporates

Hafslund AS
Kingdom of Norway, Utilities

SCOPE A- POSITIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2022**	**2023**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	>20x	>20x	17x	11x
Scope-adjusted debt/EBITDA	0.5x	0.8x	1.6x	2.1x
Scope-adjusted free operating cash flow/debt	103%	16%	-5%	0%
Liquidity	>200%	>200%	>200%	>200%

Rating rationale

Hafslund's A- issuer rating is based on a BBB+ standalone credit assessment and a one-notch uplift for the utility's status as a government-related entity. While we see an unchanged potential for further ratings upside –as signalled by the Positive Outlook–, this is accompanied by uncertainties about Hafslund's medium to long-term financial risk profile. Recent credit metrics stand at very strong levels; however, the company's increasing investment ambitions put some pressure on leverage and internal funding capacity in the medium term. In addition, the level of achievable wholesale electricity prices in the Nordics will largely determine the credit metrics and the overall financial setup. While above-average power prices are expected to remain supportive to Hafslund's operating cash flow, there is currently little visibility on the long-term level of achievable prices. As a result, we need more comfort on the company's medium to long-term financial risk profile before a rating upgrade would be warranted.

Outlook and rating-change drivers

We have maintained the Positive Outlook on the rating which continues to reflect the possibility that Hafslund will maintain a stronger financial risk profile, supported by above-average power prices and strong profitability. However, ratings upside remains dependent on the level of achievable power prices and to which extent Hafslund will use the still very large headroom on its leverage for investments. Overall, we see a good chance that Hafslund will keep its leverage, as measured by the Scope-adjusted debt/EBITDA ratio, at around 2.0x.

A rating upgrade could be warranted if credit metrics, as exemplified by a Scope-adjusted debt/EBITDA ratio of around or below 2.0x, were sustained.

A negative rating action, such as a revision to a Stable Outlook, could be triggered if our expectation of leverage remaining at or below 2.0x (Scope-adjusted debt/EBITDA) became less likely. This could be driven by significantly lower-than-expected power prices, higher-than-expected capex, or structural transactions that weigh on the company's financial risk profile.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
5 June 2024	Affirmation	A-/Positive
5 June 2023	Upgrade	A-/Positive
7 June 2022	Outlook change	BBB+/Positive
9 July 2021	New	BBB+/Stable

Ratings & Outlook

Issuer	A-/Positive
Short-term debt	S-1
Senior unsecured debt	A-

Analysts

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Related Methodologies

General Corporate Rating Methodology; October 2023

European Utilities Rating Methodology; March 2023

Rating Methodology – Government Related Entities; July 2023

Related Research

ESG considerations for the credit ratings of utilities; April 2021

Utilities credit outlook: slightly positive, favouring power generators vs grid/network operators, February 2024

Nordic utilities: north-south price gap benefits southern generators; TSOs also gain, Nov 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Norway's 2nd largest power producer; leading position in the Nordics as a profitable and low-cost hydro power generator (positive ESG factor) with significant water reservoir capacity • Long-term, supportive and committed municipality owner, justifying an uplift from the standalone credit assessment • Widened outreach through new exposure to district heating and cooling business via Hafslund Celsio (formerly Fortum Oslo Varme) which contributes to a circular economy (positive ESG factor) • Very strong profitability – as measured by Scope-adjusted EBITDA margin of more than 60% and Scope-adjusted ROCE of about 15% on average • Currently very low leverage and very strong interest coverage metrics • Indirect exposure to robust grid operations through recurring dividend inflow from its 50% ownership in Norway's largest electricity distribution grid company (Elvia) via Eidsiva	• Large exposure to the volatility in power prices for its unhedged power production output • Weak cash flow and weak financial credit ratios when market prices are low, as exemplified with FY 2020 numbers • High volatility of free operating cash flow • Limited geographical outreach within and outside of Norway

Positive rating-change drivers	Negative rating-change drivers
• Sustained leverage of around 2.0x or lower	• Outlook reversion to Stable: Non-materialisation of a leverage of about 2.0x or lower • Loss of GRE status due to change of ownership which is deemed remote

Corporate profile

Hafslund is a Norwegian utility that is wholly owned by the City of Oslo. Although the company's corporate history is very long, the group structure changed significantly in 2019 with the swap of assets with Eidsiva Energi, thereby forming two companies with a primary focus on either power generation or grid operation. Today, Hafslund is Norway's second largest power producer, with operating responsibility for an annual hydro power production of about 20 TWh. It also has a joint venture in grid operations (Elvia) through its 50% stake in Eidsiva Energi AS (A-/Stable) and has a 49% interest in Fredrikstad Energi AS. Its main hydropower assets are placed in Hafslund Kraft (of which Eidsiva Energi owns 43.5%). In Q2 2022, Hafslund also became the majority owner (60%) of Hafslund Celsio (previously known as Fortum Oslo Varme), with Infranode and HitecVision each owning 20%.

Financial overview

				Scope estimates		
Scope credit ratios	**2021**	**2022**	**2023**	**2024E**	**2025E**	**2026E**
Scope-adjusted EBITDA/interest cover	17x	>20x	>20x	17x	11x	10x
Scope-adjusted debt/EBITDA	1.2x	0.5x	0.8x	1.6x	2.1x	2.3x
Scope-adjusted debt (excluding shareholder loans)/EBITDA	0.7x	0.2x	0.4x	1.0x	1.5x	1.6x
Scope-adjusted funds from operations/debt	76%	144%	-3%	5%	13%	18%
Scope-adjusted free operating cash flow/debt	67%	103%	16%	-5%	0%	5%
Scope-adjusted EBITDA in NOK m						
EBITDA	9,611	19,806	12,971	9,244	7,616	7,563
Other items[1]	513	450	1,196	620	650	650
Scope-adjusted EBITDA	**10,124**	**20,256**	**14,167**	**9,864**	**8,266**	**8,213**
Funds from operations in NOK m						
Scope-adjusted EBITDA	10,124	20,256	14,167	9,864	8,266	8,213
less: (net) cash interest paid	(605)	(549)	(700)	(573)	(725)	(796)
less: cash tax paid per cash flow statement	(273)	(4,701)	(13,838)	(8,478)	(5,244)	(4,128)
Funds from operations (FFO)	**9,246**	**15,006**	**(371)**	**813**	**2,297**	**3,289**
Free operating cash flow in NOK m						
Funds from operations	9,246	15,006	(371)	813	2,297	3,289
Change in working capital	(650)	(527)	162	74	31	(1)
Non-operating cash flow	264	(2,806)	3,238	-	-	-
less: capital expenditure (net)	(590)	(870)	(1,217)	(1,674)	(2,331)	(2,390)
less: lease amortisation	(19)	(29)	(49)	(49)	(49)	(49)
Free operating cash flow (FOCF)	**8,251**	**10,774**	**1,763**	**(835)**	**(53)**	**850**
Net cash interest paid in NOK m						
Net cash interest per cash flow statement	605	549	700	573	725	796
Change in other items	-	-	-	-	-	-
Net cash interest paid	605	549	700	573	725	796
Scope-adjusted debt in NOK m						
Reported gross financial debt	13,591	16,029	15,363	14,270	14,188	14,643
add: subordinated debt (shareholder loans)	5,264	7,339	5,422	5,422	5,422	5,422
less: cash and cash equivalents	(6,988)	(13,497)	(10,239)	(4,497)	(2,051)	(1,546)
add: non-accessible cash	364	558	337	253	190	142
add: pension adjustment[2]	-	-	-	-	-	-
Scope-adjusted debt (SaD)	**12,231**	**10,429**	**10,883**	**15,448**	**17,749**	**18,660**

1 Recurring dividend income from associates
2 No adjustments for pension obligations given a constant overfunding of outstanding pensions.

Table of Content

Environmental, social and governance (ESG) profile[3]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)		Labour management		Management and supervision (supervisory boards and key person risk)	
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

Cheap and clean electricity generation

As a producer of clean hydroelectric power and to an increasing extent other renewable energy sources, Hafslund's business model revolves around sustainability, fulfilling the UN's Sustainable Development Goal #7 (Affordable and clean energy). This is signalled by the company's very low carbon intensity, with a specific carbon intensity of less than 20 gCO2e/kWh. Such a position: i) rules out transition risks; and ii) ensures high utilisation of the hydropower generation portfolio and a very strong position in the region's merit order, a high margin, robust cash flow generation and limited headwinds from regulation and political interference. Moreover, the exposure to hydropower generation guarantees a consistent GRE status.

Growth areas focused on sustainability

While the potential for hydro power generation in Norway has largely been exploited, Hafslund focusses its growth projects on other sustainable areas such as wind (e.g. the acquired Tonstad onshore wind park and the equity stake in Blåvinge offshore wind farm), solar, electric charging and carbon capture.

Heat business aiming at circular economy

Moreover, Hafslund's exposure to the generation of district heating and cooling is primarily based on waste incineration, which promotes a circular economy. Currently, the company builds the world's first climate-positive waste incineration plant with carbon capture and storage capabilities.

Very strong ESG rating

We acknowledge Hafslund's well-integrated ESG framework and ambitions, including publications of green financing reports. The company has received an ESG Second Party Opinion from Standard&Poor's, attaining a 'Dark Green Rating' (highest possible outcome). The company has issued three green bonds, with proceeds used exclusively for low-carbon solutions and climate change adaption. All projects take into account environmental concerns, social impacts, landowners and potential local resistance.

No issues on Governance

The company applies market standard Governance Principles. We did not observe any negative credit-relevant factors pertaining to Corporate Governance.

[3] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: BBB+

Business risk profile is the weakest link of Hafslund's issuer rating

Hafslund's business risk profile is considered good, but overall a rating constraining factor, mainly due to diversification effects and the company's high exposure to industry-inherent risks related to the production of electricity from unregulated generation capacity.

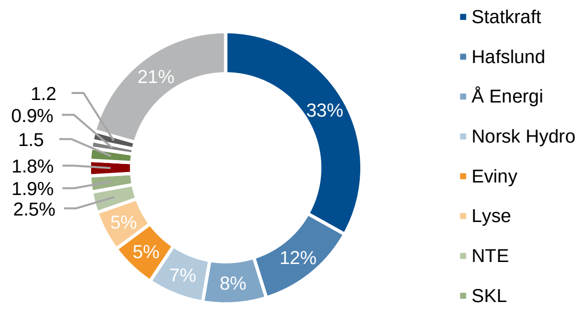
Leading electricity generator in Norway with a low-cost generation capacity

Hafslund's business risk profile remains largely underpinned by its strong market position as Norway's second largest electricity producer (see Figure 1), mainly from clean and low-cost hydroelectric capacity, which ensures a very strong position in the region's merit order and enables the provision of peak load capacity thanks to the company's significant water reservoirs, which back up roughly 50% of annual production volumes.

Growing cash flow exposure outside of unregulated electricity generation reduces business risks

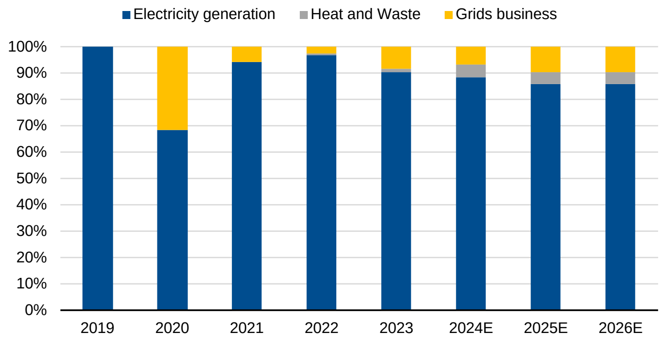
The successful integration of Hafslund Celsio (formerly Fortum Oslo Varme), Norway's largest district heating and cooling company, has put Hafslund's operations on a broader footing and is expected to become an important growth driver for the company. This is coupled with a gradual increase in cash generation through indirect exposure to regulated grid activities and associated dividend payments from equity stakes in associated companies, primarily Eidsiva Energi (see Figure 2). However, Hafslund's exposure to unregulated electricity generation remains the core of its activities. Nonetheless, the growing cash flow exposure to power distribution and district heating/cooling will overall reduce the cash flow volatility related to the utility's core exposure to spot market prices due to limited hedging activities. While we expect supportive electricity prices over the next few years, in a range well above historical averages, adverse price movements, e.g. due to heavy rainfall or other external shocks, cannot be ruled out.

Figure 1: Estimated market shares in Norwegian hydropower generation



Sources: Scope

Figure 2: Relative segment split*



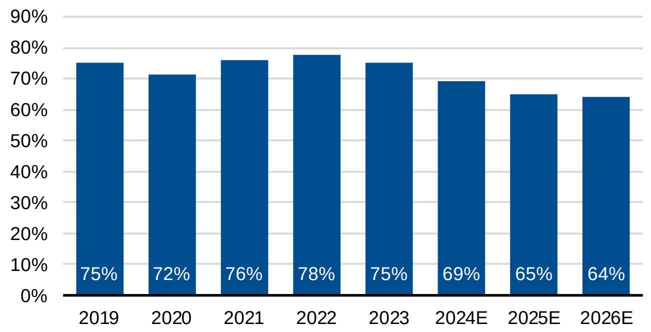
* EBIT for electricity and heat business and dividend income for the grids business used as proxies for the segment split

Sources: Hafslund, Scope estimates

Consistently strong profitability

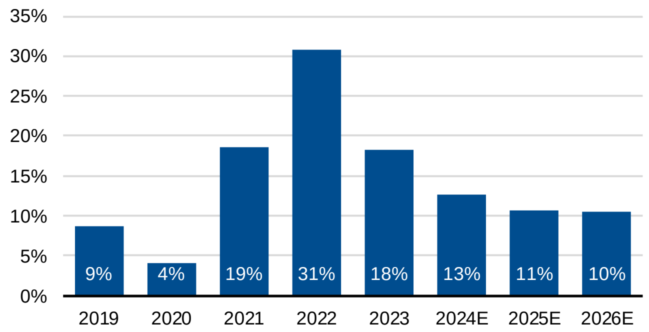
Continued favourable market fundamentals and the company's setup are expected to result in consistently strong profitability, as measured by Scope-adjusted EBITDA margin and Scope-adjusted ROCE. The group's consolidated EBITDA margin (excluding income from associates) is well above 60%, given the low operating cost base of Hafslund's core power generation business. ROCE is similarly strong, averaging 15%. The operating costs for hydropower production, such as pumping, energy purchases and transmission costs, are relatively low and vary with electricity prices and volumes. As the cost base is relatively low in absolute terms, margin volatility tends to be low. Despite the dilutive effect of the district heating and cooling business on the group's margin (the EBITDA margin is at a significantly lower level of 25-35% compared with electricity generation due to higher operating costs for raw material procurement and the operation of incineration plants), this is unlikely to put significant pressure on Hafslund's margin profile in the coming years.

Figure 3: Very strong Scope-adjusted EBITDA margin



Sources: Hafslund, Scope estimates

Figure 4: Solid but more volatile return on capital employed (Scope-adjusted ROCE)



Sources: Hafslund, Scope estimates

Geographical outreach, concentration risks and high exposure to industry-inherent risk remain rating constraints

However, the assessment is constrained by Hafslund's high exposure to a volatile price environment in unregulated power generation and its core exposure to spot market prices due to limited hedging activities. While we assume supportive electricity prices in the next few years, well above historical averages, adverse price developments, e.g. due to heavy rainfall, cannot be ruled out. Business risks are also signalled by limited geographical diversification and concentration risks related to electricity price zones and the largest power generation assets.

2023 incident at the Braskereidfoss power plant not pointing to severe structural credit weaknesses

The incident at Braskereidfoss power plant whose dam broke following heavy rainfall and an inability to open the floodgates points to potential concentration risks in Hafslund's power generation portfolio. The affected power plant site is one of the smallest sites and is not causing significant disruption on power generation volumes and capex. However, the incident flags some concentration risks across Hafslund's power generation fleet of 80 hydro power plants (30% of annual production volumes concentration within three power plants).

Financial risk profile: A-

Adjustments

In terms of adjustments and the calculation of credit metrics, we note that the company's 50% ownership in Eidsiva Energi is accounted for as an equity investment in the group's IFRS accounts. In our Scope-adjusted EBITDA, however, we include the recurring dividend from Eidsiva Energi. Our Scope-adjusted debt fully accounts for shareholder loans provided by the City of Oslo. They do not qualify as hybrid debt positions. However, as the exposure to such loans is significant (~30% of gross debt at YE 2023) and interest on them could be eliminated in case of operating losses, we show the effect on the Scope-adjusted leverage.

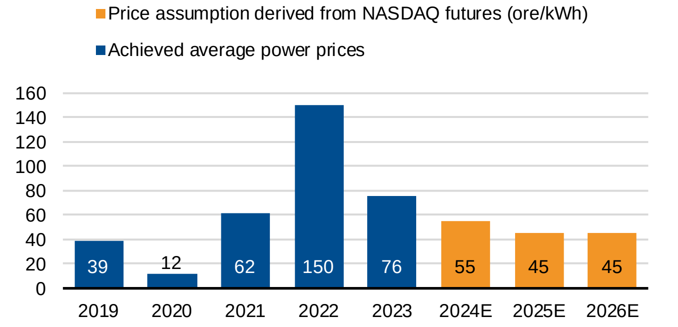
Above-average electricity prices continue to support solid credit metrics …

As a low-cost producer of electricity from hydro capacities, Hafslund's financial risk profile has been supported significantly over the last three years by extraordinarily high electricity prices. We believe that Hafslund's financial profile will remain strong over the next few years in light of above-average – albeit retreating – electricity prices in the relevant price zones as indicated by futures prices (see Figure 5). Paired with solid recurring income from associates, primarily Eidsiva, Scope-adjusted EBITDA is expected to stand between NOK 8bn and NOK 10bn per annum over the next three years (see Figure 6), which provides continued support to solid credit metrics.

… but ambitious capex programme increasingly weighs on metrics

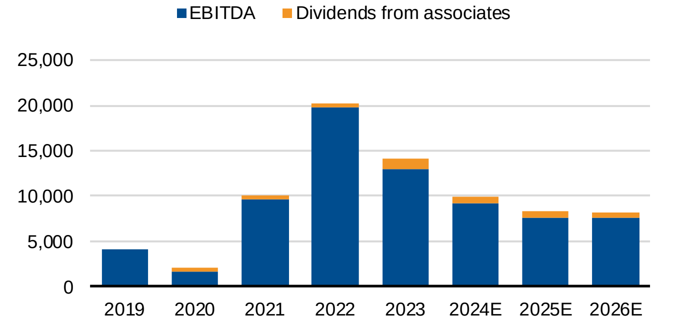
However, Hafslund's grown ambitions to deploy the consistently low leverage through significant capex (estimated at an average of NOK 2.1bn over the next three years) which stands at a materially higher level than the historical average (NOK 900m) and the level of associated operating returns provide some uncertainty about medium-to-long-term levels of credit metrics. While we continue to see potential ratings upside from strengthened financial risk profile, there needs to be improved visibility about the impact of investments and the longer-term price curve for electricity prices.

Figure 5: Electricity prices



Sources: Hafslund, NASDAQ, Scope estimates

Figure 6: Scope-adjusted EBITDA in NOK m



Sources: Hafslund, Scope estimates

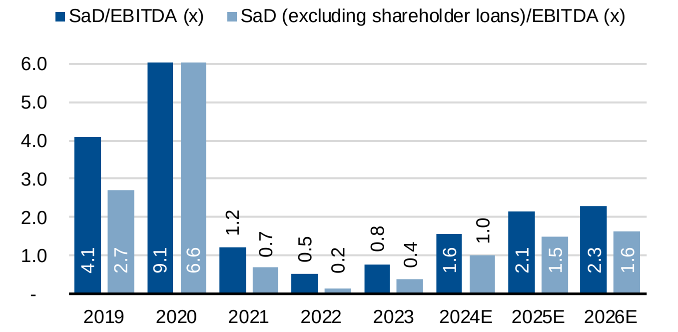
Leverage currently at a very strong level …

Leverage, as measured by Scope-adjusted debt/EBITDA, has remained at a very low level of less than 1.0x over the past two years, supported by strong operating performance and consistent cash generation. As a result, the leverage is considered to be very solid, especially considering the company's significant exposure to subordinated shareholder loans, which represent more than 30% of total interest-bearing debt.

… but significant investment programme could result in material increase of debt and leverage

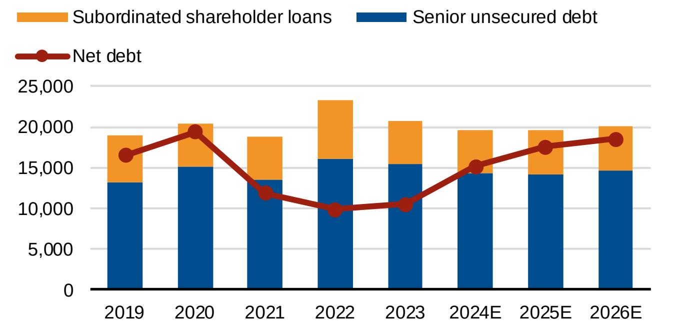
The further development of Hafslund's debt will continue to depend to a large extent on the pace of implementation of the investment programme and the associated returns, as well as on the achievable electricity prices. We project that debt will increase significantly to NOK 18.6bn at the end of 2026 (NOK 13.4bn excluding shareholder loans) from NOK 10.9bn at the end of 2023, based on the expectation that Hafslund will largely use its very high cash buffer (NOK 10bn at the end of 2023) for tax and investment payments and also take on some debt for growth investments (average capex for 2024-2026 per annum is assumed to be NOK 2.1bn, compared with an average of NOK 900m per annum over the last three years). This development is coupled with an expected deterioration in EBITDA as a result of weakening electricity prices. As a result, we project leverage to trend to around 2.0x in 2026, which could also be the peak as capex is expected to be reduced and investments will strengthen operating cash flow.

Figure 7: Leverage expected to revert to a higher level on 'normalised' achievable electricity wholesale prices



Sources: Hafslund, Scope estimates

Figure 8: Debt development in NOK m

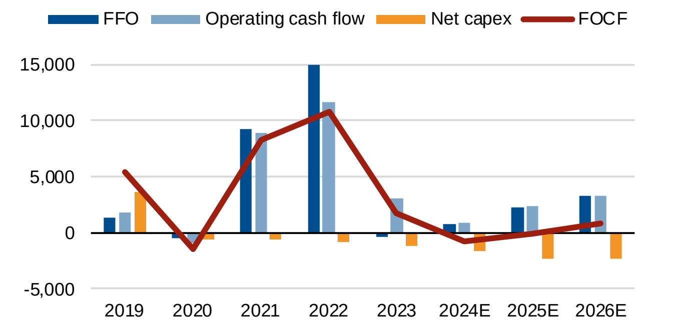


Sources: Hafslund, Scope estimates

Solid internal financing capacity but volatile FOCF

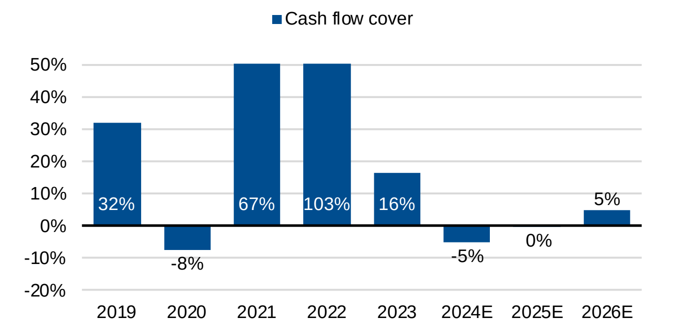
Increasing capex and opportunistic growth opportunities will put pressure on the generation of positive free operating cash flow (FOCF). We forecast that aggregated FOCF over the next three years will become slightly negative (-NOK 50m), which is somewhat offset by the very strong FOCF earned over the last few years. Moreover, we believe that FOCF will revert to the positive territory in the medium term after capex is scaled back. As such, this does not constitute a major credit concern.

Figure 9: Huge swings pertaining to FOCF generation (all in NOK m) …



Sources: Hafslund, Scope estimates

Figure 10: … leading to volatile cash flow cover

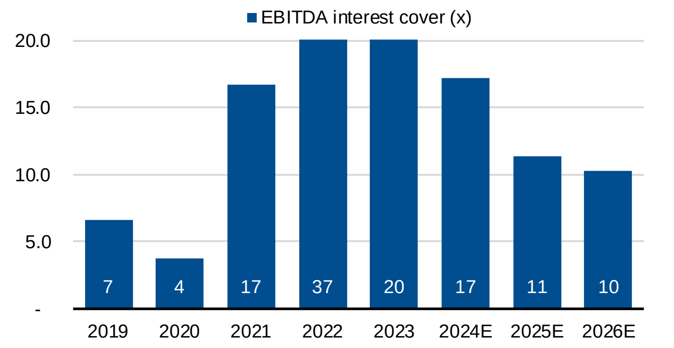


Sources: Hafslund, Scope estimates

Strong interest coverage expected despite rising interest rates and growing debt exposure

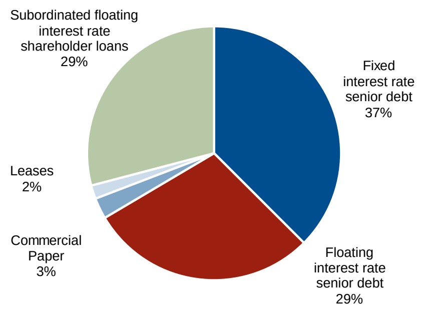
Debt protection, as measured by EBITDA to net interest paid, remained very strong (more than 20x over the last few years) despite the utility's significant usage of floating rate debt (more than 50% of total interest-bearing debt before interest rate swaps). We project that interest coverage will remain at a strong level of around 10x over the next few years, despite the projected downward trend in EBITDA and a significant increase in net interest payments, which is a consequence of rising net financial debt, reduced cash inflows from interest income and a heightened average effective interest rate of around 4.5%.

Figure 11: Solid debt protection



Sources: Hafslund, Scope estimates

Figure 12: Significant exposure to floating rate debt at YE 2023 before interest rate swaps



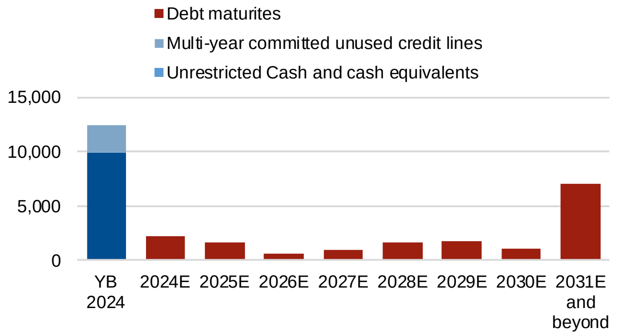
Sources: Hafslund, Scope estimates

Adequate liquidity and well-distributed maturity schedule

The utility's liquidity profile remains very strong despite forecasted pressure from potential capex and large tax payments. Between 2024 and 2026, Hafslund faces refinancing needs of about NOK 4.6bn (including NOK 0.5bn of commercial paper). Such maturities and potentially negative FOCF can comfortably be covered by the utility's unrestricted cash buffer of roughly NOK 10bn at YE 2023 and available credit facilities. As of YE 2023, Hafslund had a NOK 2.5bn committed unused credit facility with expiry in Nov 2028.

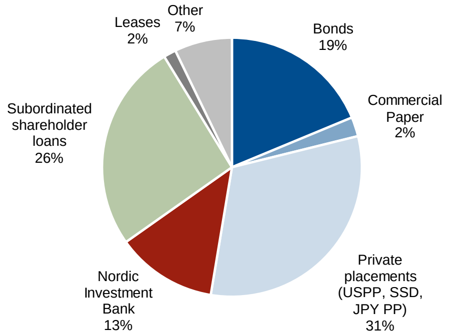
Whilst we believe Hafslund is likely to refinance maturing debt pertaining to bonds and private placements through the issuance of similar debt positions, such positions can comfortably be covered by available cash sources. Moreover, we highlight the company's wide access to different funding sources, including bonds, bank debt, private placement debt and shareholder loans.

Figure 13: Debt maturity schedule at YE 2023 (in NOK m)



Sources: Hafslund, Scope

Figure 14: Diversified funding structure as of YE 2023



Sources: Hafslund, Scope

Balance in NOK m	2024E	2025E	2026E
Unrestricted cash (t-1)	9,902	4,244	1,861
Open committed credit lines (t-1)	2,500	2,500	2,500
Free operating cash flow (t)	(835)	(53)	850
Short-term debt (t-1)	2,254	1,665	643
Coverage	**513%**	**402%**	**811%**

Supplementary rating drivers: + 1 notch

Prudent financial policy

Hafslund's financial policy is deemed prudent. It focuses on retaining an investment-grade rating and active monitoring of quantitative and qualitative factors that affect creditworthiness in order to maintain high financial flexibility. Given the company's status as a municipality-owned entity, we see little risk that Hafslund will prioritise shareholder remuneration over creditor protection. While the company does not publicly stick to specific minimum/maximum financial thresholds, we believe it steers its capex and shareholder remuneration in a way that will not jeopardise the rating.

Status as government related entity grants one-notch uplift

The rating continues to incorporate a one-notch uplift to the standalone credit assessment of BBB+, resulting in an A- issuer rating. This follows the framework set out in our rating methodology for government-related entities with a bottom-up rating approach, reflecting a conservative assessment of the capacity of the public sponsor (the City of Oslo, which is the 100% shareholder) to provide a credit uplift and its willingness to provide financial support if needed (something that is deemed highly remote). We deem the public sponsor's creditworthiness to be significantly higher than Hafslund's standalone credit assessment, signalling a high capacity for a credit uplift. We assess the public sponsor's willingness to be significant, given Hafslund's primary exposure to hydropower generation assets, which need to be in the hands of public authorities. Overall, the rating uplift is restricted to just one notch, in line with other Scope-rated Norwegian utilities with majority or full public ownership but no explicit guarantees on their debt or financial support.

Long-term and short-term debt ratings

The rated debt is issued by Hafslund AS. Senior unsecured bonds display standard bond documentation, including pari passu and negative pledge.

Senior unsecured debt rating: A-

Senior unsecured debt is rated A-, in line with the rating action on the underlying issuer rating.

Short-term debt rating: S-1

The S-1 short-term debt rating is based on the underlying A-/Positive issuer rating and a consistently robust short-term debt coverage, as well as good access to external funding from banks and debt capital markets.

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