Haugaland Kraft AS
Norway, Utilities

SCOPE BBB+ POSITIVE

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021	2022E	2023E
Scope-adjusted EBITDA/interest cover	18.3x	69.9x	91.1x	48.5x
Scope-adjusted debt/EBITDA	4.0x	1.0x	0.0x	0.4x
Scope-adjusted funds from operations/debt	16%	108%	>200%	26%
Scope-adjusted free operating cash flow/debt	neg.	44.1%	>200%	neg.

Rating rationale

The issuer rating reflects Haugaland Kraft's good segment diversification, especially through the combination of robust infrastructure segments such as monopolistic power distribution and fibre broadband services. The company is also increasingly exposed to profitable, environmentally friendly, low-cost hydropower production (positive ESG factor) via its 59.7% stake in Sunnhordland Kraftlag AS (SKL). Although SKL adds segment diversification, its unhedged production output also indirectly adds volatility through a high electricity price exposure. The financial risk profile has been relatively conservative but also volatile given the inherent indirect volatility risk via SKL. The issuer rating reflects a stand-alone credit quality of BBB and a one-notch uplift based on our assessment of the anticipated capacity and willingness of the Norwegian municipal owners to provide support, assessed in accordance with our Government Related Entities Methodology.

Outlook and rating-change drivers

The Positive Outlook reflects our expectation that Haugaland Kraft's financial risk profile will remain much more conservative than anticipated given the prospect of higher-than-normal achievable power prices continuing into the medium term. It also assumes that the company will maintain a high equity ratio, paired with prudent investment and growth ambitions. Further, it assumes Haugaland Kraft will remain a diversified utility with operations in grids, power sales and fibre broadband as well as a majority owner in SKL.

A rating upgrade could be warranted if power prices remain high, which keep credit metrics conservative. This could be exemplified by a Scope-adjusted debt/EBITDA of below 2x, and the current financial strategy and external growth ambitions as indicated by management would keep leverage within this range. A rating upgrade could also occur in the longer term if the more stable infrastructure business contributed more to overall group EBITDA, leading to lower volatility and an improved business risk profile.

A negative rating action (i.e. back to a Stable Outlook) is possible if the financial risk profile weakened due to lower wholesale prices or debt-financed transactions or investments, exemplified by a Scope-adjusted debt/EBITDA of 2x-4x. The loss of the company's status as a government related entity following a change in ownership could also trigger a downgrade.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
24 Nov 2021	New	BBB+/Stable

Ratings & Outlook

Issuer	BBB+/Positive
Short-term debt	S-2
Senior unsecured debt	BBB+

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Related Methodologies

Corporate Rating Methodology; July 2022

Rating Methodology: Government Related Entities Methodology, May 2022

European Utility Methodology, March 2022

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Bloomberg: RESP SCOP

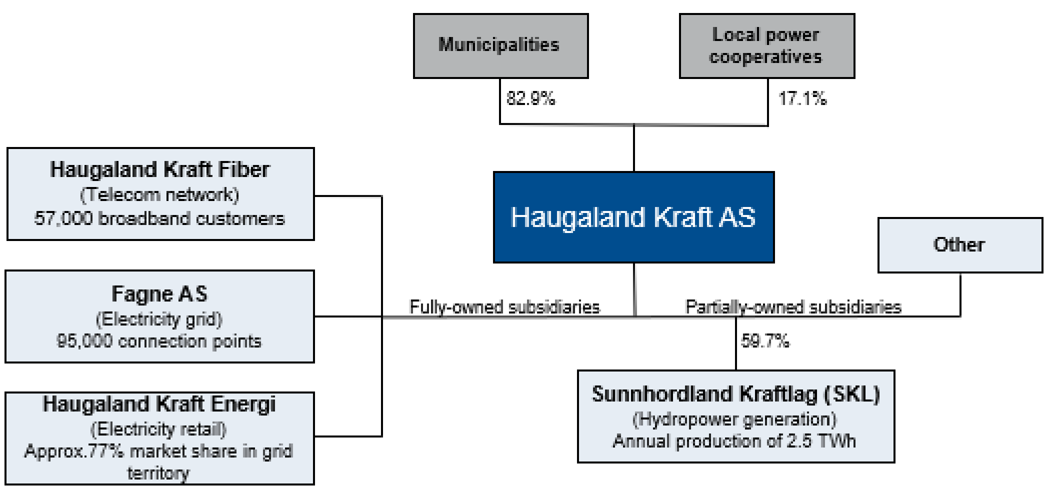
Positive rating drivers	Negative rating drivers
• Diversified business model that includes exposures to monopolistic power distribution, fibre broadband, power generation and retail power sales • Supportive, committed municipal owners, justifying an uplift to the stand-alone rating in accordance with our government-related entities methodology • Intention and history of maintaining a conservative financial risk profile	• Ambitious investments that are putting pressure on free operating cash flow • Plans for further structural transactions, posing certain business risks if changing organisational structure • Large indirect exposure via SKL to volatile power prices from unhedged production output

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA of below 2x (the current financial strategy and external growth ambitions would keep leverage within this range) • In the longer term, the infrastructure business contributing more to overall group EBITDA, leading to lower volatility and an improved business risk profile	• Scope-adjusted debt/EBITDA of 2x-4x due to weaker-than-expected financial risk profile resulting from lower wholesale prices or debt-financed transactions or investments • Loss of status as a government-related entity following a change in ownership

Corporate profile

Haugaland Kraft is a Norwegian utility company operating across several segments that include hydropower generation, energy transmission and distribution, and telecommunications networks. Most operations are in south-western Norway. Haugaland Kraft is owned by twelve municipalities (82.9%) and three utility cooperatives (17.1%) in its service territory. The hydropower generation business operates within SKL, an independent company in which Haugaland Kraft owns 59.7% (consolidated into Haugaland Kraft's financial figures).

Figure 1: Simplified organisational structure



Source: Company

Financial overview

				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	51.9x	18.3x	69.9x	91.1x	48.5x	40.9x
Scope-adjusted debt/EBITDA	1.3x	4.0x	1.0x	0.0x	0.4x	0.7x
Scope-adjusted funds from operations/debt	35%	16%	108%	>200%	26%	50%
Scope-adjusted free operating cash flow/debt	neg.	neg.	44.1%	>200%	neg.	1.5%
Scope-adjusted EBITDA in NOK m						
EBITDA	1,293	667	2,348	4,907	3,574	3,378
add: other adjustments	-	-	-	-	-	-
Scope-adjusted EBITDA	**1,293**	**667**	**2,348**	**4,907**	**3,574**	**3,378**
Funds from operations in NOK m						
Scope-adjusted EBITDA	1,293	667	2,348	4,907	3,574	3,378
less: (net) cash interest paid	-25	-36	-34	-54	-74	-82
less: cash tax paid per cash flow statement	-506	-328	-103	-1,036	-3,083	-2,149
Other changes/adjustment for non-cash items	-190	122	238	-	-	-
Funds from operations	**573**	**425**	**2,449**	**3,817**	**417**	**1,148**
Free operating cash flow in NOK m						
Funds from operations	573	425	2,449	3,817	417	1,148
Working capital change	15	49	-157	-15	-15	-15
less: capital expenditure (net)	-817	-1,082	-1,293	-1,200	-1,100	-1,100
Free operating cash flow	**-230**	**-608**	**999**	**2,603**	**-698**	**32**
Scope-adjusted debt in NOK m						
Reported gross financial debt	2,024	2,725	2,643	4,043	4,633	4,923
less: cash and cash equivalents	-453	-134	-461	-3,954	-3,118	-2,693
add: non-accessible cash	63	64	86	85	85	85
add: pension adjustment	-	-	-	-	-	-
add: other adjustments	-	-	-	-	-	-
Scope-adjusted debt	**1,634**	**2,655**	**2,267**	**174**	**1,600**	**2,316**

Table of Content

Environmental, social and government (ESG) profile[1]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Green leaf	Labour management		Management and supervision (supervisory boards and key person risk)	Grey leaf
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)	Grey leaf
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)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

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

Well-integrated ESG framework and ambitions, including publication of green financing reports

Haugaland Kraft's operations are mostly in power generation (hydro) and electricity distribution. The generation of hydro power, a renewable energy with low emissions, is a positive ESG factor. We also highlight Haugaland Kraft's good ESG standing in financial markets as illustrated by its green bond issuance earlier this year. Haugaland Kraft has good corporate governance

[1] The ESG profile only evaluates the extent to which ESG factors are credit relevant. Our evaluations are not mutually exclusive or collectively exhaustive as these factors overlap and evolve. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality.

Business risk profile: BBB

Blended industry risk profile

In accordance with our rating methodology for utilities, we have assessed each of the company's segments separately, taking their different characteristics into account.

The general European power generation market is highly cyclical with medium barriers to entry, while the regulated distribution business has low cyclicality and high barriers to entry. Telecoms and fibre-cable services have low cyclicality, with utility-like demand characteristics. Barriers to entry vary somewhat across the different sub-industries, but cyclicality is medium overall, as barriers to entry can be lower when including competition in rent network capacity. Finally, the exposure to retail power sales comes with low cyclicality and barriers to entry.

Ownership stake in SKL, a small power generator in Norway

Haugaland Kraft owns 59.7% of SKL, which produces about 2.5 TWh. This makes it a small power generator in Norway, with less than 2% of total production. Still, a utility's size is not a major factor when assessing market position and credit quality. Moreover, the company has high capacity utilisation and its hydropower assets are low cost and are at the front of the merit order system.

Grid and fibre broadband provide stability

Haugaland Kraft's grid business serves many private customers in its service territory of Western Norway, which is credit-positive. This monopoly allows timely cost coverage and ensures a sustainable source of robust cash flow. Tariffs are determined retrospectively, guaranteeing sufficient cost coverage. The company's two other main business segments, retail power sales and broadband, have small shares of their markets. In retail power, Haugaland Kraft covers around 80% of its monopolistic network service territory, while it has around 50,000 customers in telecoms and broadband.

Positive segment diversification but limited geographical outreach

Segment diversification is good. Exposure to generation, grid, broadband and power supply is coupled with a low dependence on any single customer. However, geographical diversification is limited to south-west Norway. Moreover, there is asset concentration risk due to the high dependence in the generation portfolio on SKL's largest hydropower plants[2].

In addition, general uncertainty and volatility is high because of the uncontrollable power prices and tax regime and the potential plan of moving more into solar. The establishment of Endra Solenergi AS could lead to large-scale solar power production.

The company is also a service provider within solar, electrical charging, alarms and lighting. While these elements form only a minor part of our rating assessment, they are valuable for assessing cross-selling and customer loyalty. We consider the participation in Deep Wind Offshore more as a vehicle for early value creation than a large investment.

The group's EBITDA margin is helped by the large exposure to low-cost hydropower generation through SKL but weighed down by low-margin retail power sales. Yet Haugaland Kraft is still among the top Norwegian utility companies in terms of profitability.

[2] SKL's exposure to its largest hydropower plant makes up approximately 30% of annual production, while the three largest plants make up approximately 60% of annual production.

Financial risk profile: BBB+

Limited adjustments made to reported numbers, but SKL effect is noted

SKL is consolidated into Haugaland Kraft, but 40.6% of SKL's share capital belongs to BKK and Stord Municipality. As a result, the underlying exposure and volatility in credit metrics is lower than what appears in the financials below. As the majority owner, Haugaland Kraft controls SKL's dividend pay-outs, although we assume the 60% ratio will continue to be followed.

The group's credit metrics has been relatively conservative, with a significant equity ratio and low leverage. This is also part of its strategy given the indirect volatility risk via SKL.

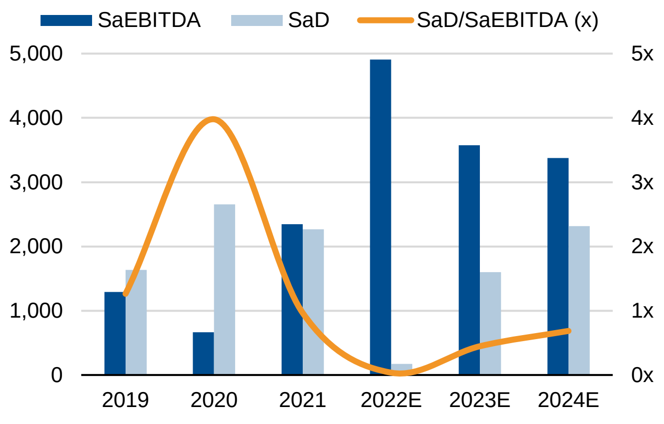
The main drivers and assumptions behind our updated credit metrics forecasts are:

- Exceptionally good results In hydropower generation in 2022 following record-high electricity prices in Norway's NO2 zone; a decline in power prices in 2023 and 2024 and thus in free cash flow, also given much higher taxes assumed to be paid next year
- More stable revenues and EBITDA from the grid segment; in broadband, double-digit growth in 2021 and mid-single-digit growth (including Afiber) in the medium term
- Expected capex increases in the next few years, mostly due to continued high grid investments and growth in broadband and power generation; no expansionary large-scale solar investments assumed

Leverage expected to remain low in the short to medium term

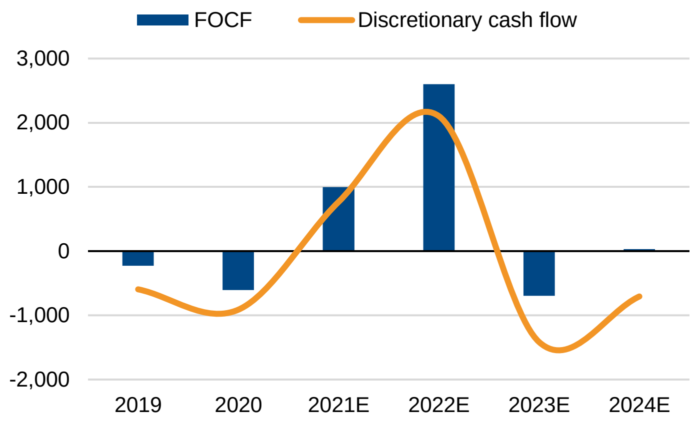
Following the exceptional situation in YE 2022 of the nearly net cash position, we expect leverage to increase towards 1x from 2023 due to much higher tax payments, continued high investment and stable dividends.

Figure 5: Scope-adjusted EBITDA and debt (RHS) in NOKm, and leverage development (LHS)



Sources: Scope (estimates)

Figure 6: Free and discretionary cash flow development, NOK m



Sources: Scope (estimates)

Liquidity is adequate as cash and back-up credit facilities are more than enough to cover debt maturities, which are also well distributed.

Supplementary rating drivers: +1 notch as government related entity

One-notch uplift for status as government-related entity

We make no adjustment for financial policy. The company aims to keep an investment-grade profile, although it has no specific credit ratio targets. It analyses capex plans against this goal before making any commitments. We see dividend pay-outs as very predictable, with an established policy of distributing 60% of net profit during the last three years.

Haugaland Kraft is ~83% owned by Norwegian municipalities, while the remaining ~17% is owned by local utility cooperatives.

We have used our Government Related Entities Methodology to assign a one-notch uplift to Haugaland Kraft's stand-alone credit rating. The one-notch uplift for ownership is in line with other Scope-rated Norwegian utilities with majority municipality ownership but no explicit guarantees.

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

Long-term and short-term debt ratings

Short term rating of S-2 and BBB+ senior unsecured rating

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 Haugaland Kraft level. The S-2 short-term rating reflects acceptable short-term debt coverage as well as good access to domestic bank loans and debt capital markets.

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