25 November 2020 Corporates

Tensio AS
Norway, Utilities

A- STABLE

Corporate profile

Tensio AS is a Norwegian utility company operating solely in regulated electricity distribution in regional and distribution network grids. The company is the second largest regional grid company in Norway and its service territory is Trøndelag County in Central Norway. The company owns and operates 29,000 km of cable (air, ground and sea), 13,000 local network stations and 130 electrical substations, and serves 260,000 customers. Tensio was formed in June 2019 by TrønderEnergi (40% owner), Nord-Trøndelag Elektrisitetsverk or NTE (40%) and Kommunal Landspensjonskasse gjensidig forsikringsselskap or KLP (20%) upon combining the grid segments of TrønderEnergi Nett and NTE Nett.

Key metrics

		Scope estimates		
Scope credit ratios	**2019PF**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover	41.6x	11.4x	8.2x	7.1x
Scope-adjusted debt (SaD)/EBITDA	2.7x	3.7x	4.9x	5.0x
Scope-adjusted funds from operations/SaD	37%	25%	18%	17%
Free operating cash flow/SaD	n/a	Neg.	Neg.	Neg.

Rating rationale

Scope Ratings has assigned an A-/Stable first-time issuer rating to Norwegian utility company Tensio AS.

The issuer rating reflects Tensio's strong business risk profile and the prospect of a weaker financial risk profile. The business risk profile assessment is driven by Tensio's sole exposure to regulated power distribution, associated with very low industry risk. Tensio's monopolistic service territory (Trøndelag County, Central Norway) for electricity distribution accounts for only 9% of Norway's population, but the level still makes Tensio the second largest distribution grid operator (DSO)neg. for electricity in Norway after Elvia. Given this monopolistic position, the lack of product and geographical diversification is not important for the rating. The market position assessment is further strengthened by our view of the robust and stable Norwegian economy and the well-established regulatory framework governed by NVE-RME. Over time, we expect the combination of the two grid companies to result in streamlined operations and, in turn, improved efficiency and profit margins.

As combining the two grid companies was done initially without transferring much debt from the two owners, relevant historical credit metrics are lacking. However, with the new financial policy confirmed, combined with its investment programme and refinancing plans, we expect the company to move closer to a normalised capital structure by the end of 2021. We project the high investment requirements to result in negative free operating cash flow (FOCF) in the medium term, which, combined with plans to increase leverage towards 5x by distributing excess capital through dividends, constrains the financial risk profile assessment. The negative discretionary cash flow will necessitate external financing. To this end, the company issued NOK 400m in commercial paper in Q4 2020 and is expected to soon issue long-term senior unsecured bonds to fulfil its ambition for a long-dated maturity profile. Overall, we assess liquidity as adequate, with undrawn credit lines also available to cover existing short-term debt.

Ratings & Outlook

Issuer rating A-/Stable

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Utilities, March 2020

Government Related Entities Methodology, July 2020

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For supplementary rating drivers, the new financial policy requires no adjustment as it is already incorporated in our financial risk profile assessment. With respect to parent support, we assign a one-notch uplift from the standalone rating of Tensio, based on the application of our Government Related Entity (GRE) rating methodology, using the bottom-up approach. Our assessment of indirect majority municipal ownership in Tensio is based on potential parent support being determined not by the standalone performance or credit quality of TrønderEnergi Nett and NTE Nett, but by the capacity and willingness of their municipal owners to provide support if needed. This rationale is also in line with that for other Scope-rated Norwegian utility peers with majority municipality ownership.

Outlook

The Stable Outlook reflects our expectation that Tensio will continue to generate cash flow from monopolistic and regulated grid operations. The Outlook also assumes the company will strive towards recapitalisation, which should result in leverage, exemplified by Scope-adjusted debt (SaD)/EBITDA, moving closer to 5x in 2021. We also assume the company will remain indirectly majority owned by Norwegian municipalities.

A positive rating action could be warranted if Tensio keeps SaD/EBITDA at a significant headroom to its leverage target, following positive free operating cash flow and reduced dividend distributions, at around 4x on a sustained basis.

A negative rating action could be triggered by a financial policy change that could significantly weaken the financial risk profile, exemplified by a SaD/EBITDA of towards 6x on a sustained basis. A reduction in indirect municipal ownership to below 50% and the loss of GRE status could also trigger a downgrade.

Rating drivers

Positive rating drivers	Negative rating drivers
• Pure monopolistic power distribution company with stable and predictable cash flows • Operating in a well-established regulatory framework in Norway • Long-term and committed majority owners, which through the municipalities indirectly have capacity and willingness for parent support	• Ambition to increase leverage through an extraordinary dividend next year to meet targeted capital structure • High investment need indicating negative FOCF in the medium term • Limited geographical outreach and short record as a combined company (i.e. not fully merged)

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Positive FOCF and reduced dividend distributions, exemplified by a SaD/EBITDA of ~ 4x on a sustained basis	• Change in financial policy that could significantly weaken financial risk profile, exemplified by a SaD/EBITDA of towards 6x on a sustained basis • Reduced indirect municipal ownership to below 50% and loss of GRE status

Financial overview

		Scope estimates		
Scope credit ratios	**2019PF***	**2020F**	**2021F**	**2022F**
EBITDA/interest cover	41.6x	11.4x	8.2x	7.1x
SaD/EBITDA	2.7x	3.7x	4.9x	5.0x
Scope-adjusted funds from operations/SaD	37%	25%	18%	17%
FOCF/SaD	n/a	Neg.	Neg.	Neg.
Scope-adjusted EBITDA, in NOK m				
EBIT	385	472	518	560
add: depreciation	300	320	300	315
Scope-adjusted EBITDA	**685**	**792**	**818**	**875**
Scope-adjusted funds from operations, in NOK m				
EBITDA	685	792	818	875
less: (net) cash interest per cash flow statement	-	-70	-100	-123
less: cash tax paid per cash flow statement	-	0	0	0
add: depreciation component, operating leases	-	-	-	-
add: other	-	-	-	-
Scope-adjusted funds from operations	**685**	**722**	**718**	**753**
Scope-adjusted debt, in NOK m				
Reported gross financial debt	2,003	2,959	4,049	4,541
less: cash, cash equivalents	-289	-147	-117	-242
add: cash not accessible	10	10	10	10
add: operating lease obligations	-	-	-	-
add: pension liability adjustment	105	105	105	105
Scope-adjusted debt	**1,828**	**2,927**	**4,047**	**4,414**
Liquidity				
Liquidity (internal and external) ratio	-	10.7x	1.5x	54x
Total available liquidity (cash & undrawn credit lines) in NOK bn	**0.6**	**0.6**	**0.6**	**0.7**

**Actual 2019 financial data only consists of the period from June to December; thus, the data here is based on proforma financial year figures.*

Business risk profile

Regulated power distribution

Given Tensio's sole exposure to regulated power distribution, we assess industry risk as low (AA according to our utility rating methodology).

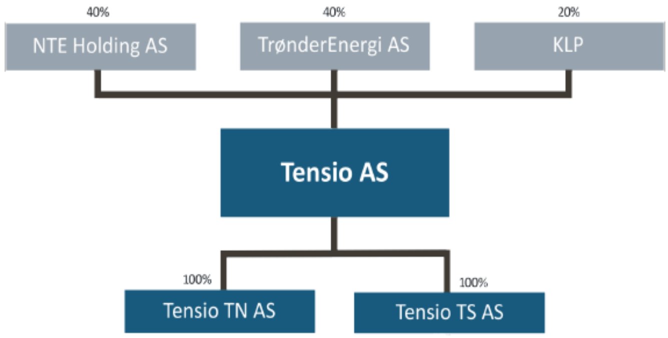
Norway's electricity distribution market is highly fragmented, with around 120 operators nationwide. However, in terms of market share, the 10 largest operators had two-thirds of the customer base (approx. 3m). DSOs hold a natural regional monopoly regardless of size, making size less important for their market position. We deem Norway's tariff-setting and regulatory framework to be well-established and reliable. Income tariffs are reviewed yearly on a two-year backward-oriented cost basis (actual and against average peers), thereby granting quick cost coverage if a DSO is more efficient than average.

Monopoly position – second largest DSO in Norway

A key positive driver for the business risk profile is Tensio's natural monopoly in Central Norway, where it provides electricity to 0.5m private customers as well as commercial and local industrial consumers. This size makes Tensio the second largest electricity DSO in Norway after Elvia (part of Eidsiva). Tensio's market position is further strengthened by our view of the robust and stable Norwegian economy and stable service territory.

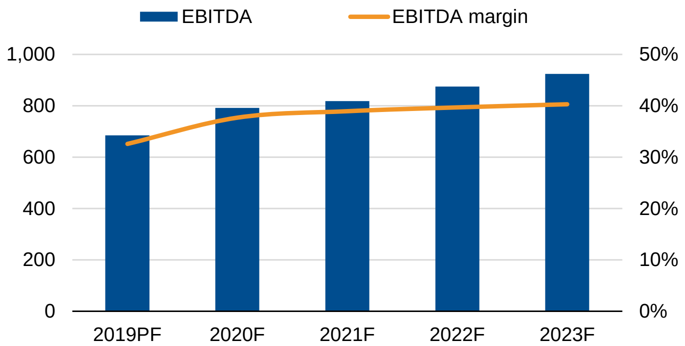
Given Tensio's monopoly, its lack of product and geographical diversification is not important for the rating. Although overall diversification is the weakest part of Tensio's competitive position assessment, the company still has a large exposure to residential customers, although the absolute number is small compared to international peers'.

Figure 1: Corporate overview of Tensio



Source: Scope / Company

Figure 2: EBITDA in NOK m (LHS) and margin % (RHS)



Source: Scope estimates

Tensio's profitability is highly dependent on regulatory conditions set by NVE-RME and its operational efficiency compared with Norwegian peers. As the company was established in 2019, historical profitability is only separately available under NTE Nett and TrønderEnergi Nett. Over time, we believe the combined Tensio will benefit from streamlined operations and thus improved efficiency and profit margins.

Cost reduction and synergies should lead to higher efficiency and profit margins

The company has identified NOK 70m in synergies and NOK 50m in cost reductions that can be achieved by 2023. The company is now on track to meet these targets after slow progress in the first 12 months. We expect cost reductions in procurement, communication and IT systems to be the main drivers this year, but also expect some restructuring costs will be needed to realise the plan, which makes the net improvement lower in our base case.

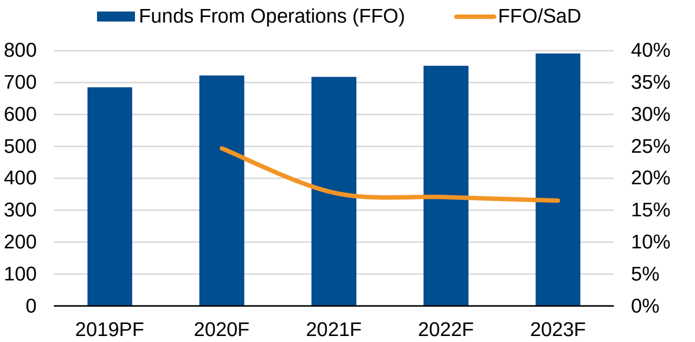
Financial risk profile

Limited historical data as a combined entity

As the company was established in June 2019, there is limited historical data for the combined entity. We also note that the combination of the two grid companies was initially done without transferring much debt from the two owners. In December 2019, the company obtained NOK 1.9bn in debt as part of the transaction, containing former bond loans from NTE and TrønderEnergi.

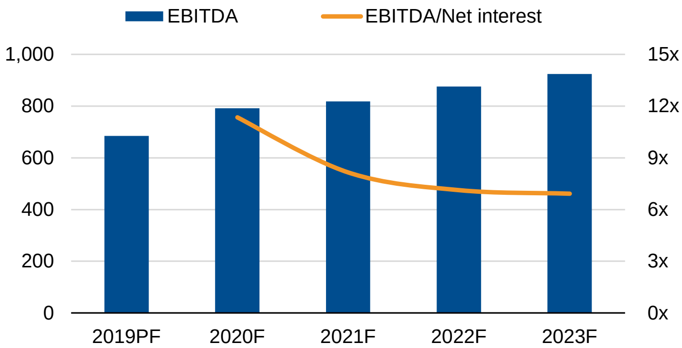
Thus, our financial assessments put less weight on historical financial data and more on forecasts. As of Q4 2020, the company has communicated a clear financial policy, including targets on dividends and capital structure, which we take into account in our assessment.

Figure 3: FFO in NOK m (LHS) and FFO/SaD (RHS)



Source: Scope estimates

Figure 4: EBITDA in NOK m (LHS) and interest cover (RHS)



Source: Scope estimates

Stable operating cash flow expected

With respect to the company's EBITDA and cash flow, we deem operating profitability to be stable, supported by Tensio's monopolistic power distribution business model. Funds from operations are expected to stay above NOK 0.7bn in the medium term, helped by zero tax payable in the coming years due to deductible investments. Further, we assume efficiency and margins to eventually improve owing to the cost reduction programme.

High investments result in negative FOCF

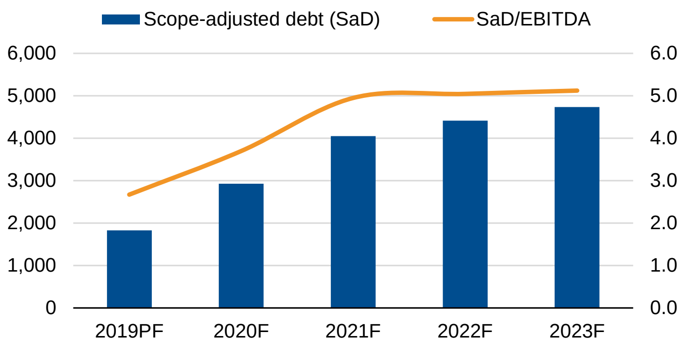
Although we expect operating cash flow to be solid and stable, the high investment requirement is likely to result in negative FOCF in the medium term. Capital expenditure is mainly for maintenance and upgrades in the regional grid, particularly in the Trondheim area. In its northern service territory, Tensio also foresees new grid investments due to the building of power production plants by other companies. Overall, the negative anticipated FOCF, combined with plans to increase leverage towards 5x through dividends, constrains the financial risk profile assessment.

Extraordinary dividend agreed to reach targeted leverage

The negative discretionary cash flow will necessitate external financing. To this end, the company issued NOK 400m in commercial paper in Q4 2020 and is soon expected to issue senior unsecured bonds.

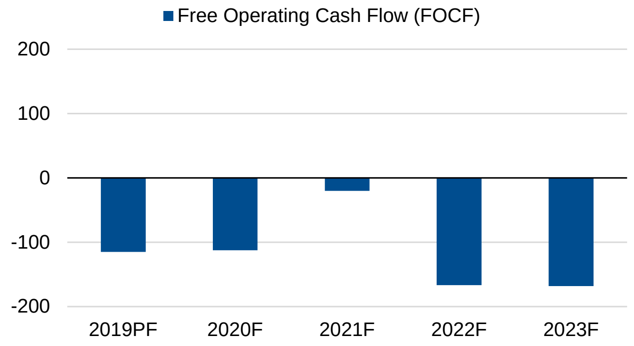
At the end of 2020, total interest-bearing debt is expected to be approximately NOK 3bn, consisting mainly of bonds and the new commercial paper, as well as some minor bank loans and leasing debt. The SaD calculation also includes around NOK 0.1bn in pension liabilities. Although we expect total debt to continue to increase in the next few years, interest coverage will remain more than sufficient and is a positive credit rating driver for the overall financial risk profile, i.e. in contrast to leverage and FOCF.

Figure 5: SaD in NOK m (LHS) and SaD/EBITDA (RHS)



Source: Scope estimates

Figure 6: FOCF in NOK m



Source: Scope estimates

New debt and refinancing to ensure long-term maturity profile

We assess liquidity as adequate. Tensio is currently arranging debt with long tenors and plans to refinance the NOK 400m in short-term commercial paper with long-term debt in 2021. Excluding the commercial paper, the next maturing debt is in March 2023. The company also has undrawn credit facilities, which after refinancing is expected to be at least NOK 0.5bn.

The company's financial flexibility is sufficient at the moment. Thus, our rating case assumes the company`s leverage ratio has room to increase. In addition to the financial policy target, the company`s outstanding bond loans have financial covenants that also restrict debt to increase too much, i.e. total debt-to-grid capital value[1] should not exceed 65%.

Supplementary rating drivers

Financial policy accounted for in financial risk profile assessment

We make no adjustment for the new financial policy, as this is already incorporated in our financial risk profile assessment. Since Tensio's establishment, its management, board and owners have been looking at the appropriate recapitalisation. As a result, the key principles of the new financial policy were defined with a debt/EBITDA target of around 5x, distribution of excess cash after investment requirements via dividends, and the maintenance of sufficient headroom to ensure an investment grade rating.

One-notch rating uplift for indirect majority municipal ownership

With respect to parent support, we assign a one-notch uplift from the standalone rating based on the application of our GRE rating methodology, using the bottom-up approach. Although Tensio does not have a single majority shareholder, we view the two utility owners (TrønderEnergi and NTE) as one due to their collective strategy, shareholder agreement and common interest in the company.

The indirect majority municipal ownership in Tensio is based on potential parent support being determined not by the standalone performance or credit quality of TrønderEnergi and NTE, but by the ability and willingness of the municipal owners to provide support if needed. Although this indirect municipality ownership is slightly more complex than a direct one, we deem it highly likely that the municipality owners would be able and willing to support Tensio, even with the lack of explicit support or guarantees. This warrants the one-notch uplift. This rationale is also in line with that for other Scope-rated Norwegian utility peers with majority municipal ownership. The one-notch uplift on the BBB+ standalone rating results in an issuer rating of A-.

[1] *Grid Capital Value - A figure that is also reportable to NVE-RME*

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