Sunnhordland Kraftlag AS
Norway, Utilities

SCOPE BBB+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021	2022E	2023E
Scope-adjusted EBITDA/interest cover	5.7x	108.3x	262.4x	178.5x
Scope-adjusted debt/EBITDA	10.9x	0.4x	Net Cash	Net Cash
Scope-adjusted funds from operations/debt	-14%	244%	Net Cash	Net Cash
Scope-adjusted free operating cash flow/debt	-37%	217%	Net Cash	Net Cash

Rating rationale

The upgrade reflects the expectation that SKL will develop a more conservative financial risk profile, based on the significantly higher power prices already achieved and the current forward market prices. Further, the issuer rating reflects a standalone credit rating of BBB as well as a one-notch uplift based on the anticipated medium capacity and willingness of SKL's owners to provide support if needed.

SKL's business risk profile (assessed at BBB-) is supported by its hydro power production (positive ESG factor) and above-average profitability compared to peers. The company also has significant reservoir capacity that provides its generation with more flexibility, which in part mitigates the company's dependency on its largest power plants.

SKL's financial risk profile (BBB+) reflects strong leverage and debt coverage. Although leverage is expected to be conservative in 2023 and 2024, free operating cash flow is estimated to be negative, affected by much higher tax payments based on 2022 and 2023 results, respectively. Finally, liquidity is adequate, supported by good access to banks and the domestic bond market.

Outlook and rating-change drivers

The Stable Outlook reflects Scope's expectation that selected financial credit metrics will remain conservative, as exemplified by Scope-adjusted debt/EBITDA below 2x, given the prospect of achieving higher-than-normal power prices in the medium term. It also assumes that the company will maintain prudent investment and growth ambitions.

A positive rating action, though remote, could be warranted by an improved business risk profile, possibly by strengthened market position, increased vertical integration or increased horisontal diversification, while keeping credit metrics conservative.

A negative rating action could be warranted by a weakened financial risk profile, due to lower achieved wholesale prices for electricity or larger investment ambitions, with Scope-adjusted debt/EBITDA moving above 2x on a sustained basis.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
28 Nov 2022	Upgrade	BBB+/Stable
13 Dec 2021	Initial rating	BBB/Stable

Ratings & Outlook

Issuer	BBB+/Stable
Senior unsecured debt	BBB+

Analyst

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Related Methodologies

Corporate Rating Methodology; July 2022

European Utilities Rating Methodology; March 2022

Government Related Entities Rating Methodology; May 2022

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Rating and rating-change drivers

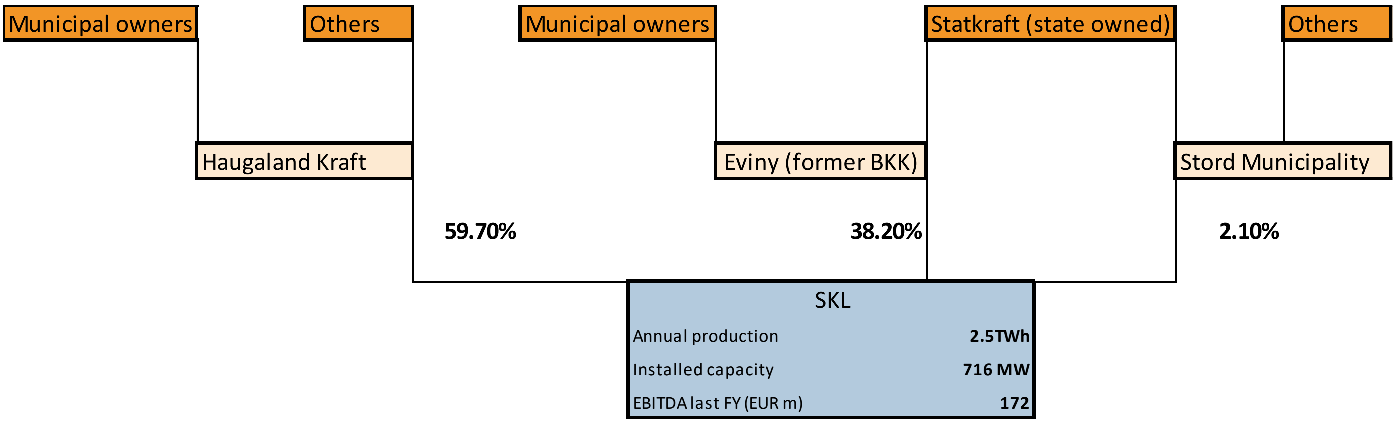
Positive rating drivers	Negative rating drivers
• Profitable, low-cost hydropower production (positive ESG factor) with fairly high reservoir capacity and natural inflow from glaciers • Long-term, indirect municipality ownership justifying the status as government-related entity and a one-notch uplift from stand-alone rating	• Low geographical and business diversification • High dependency on largest generating assets • Fully exposed to volatile power prices through unhedged power production

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile, i.e., stronger market position, increased vertical integration or horisontal diversification, while keeping credit metrics conservative	• Weaker financial risk profile, exemplified by a Scope-adjusted debt/EBITDA sustained above 2x • More aggressive growth ambitions or sustained weaker power prices and market conditions • Loss of municipal ownership

Corporate profile

SKL is a Norwegian utility founded in Stord, Norway in 1946. Over the years the company has transformed into a pure-play hydro power producer, and today it produces 2.5TWh yearly. SKL fully owns and operates 20 hydro power plants, mainly located in the Rogaland and Vestland counties in Norway. In addition, the company has ownership interests in 15 other hydro power plants in the region. SKL is directly owned by utilities Haugland Kraft AS (59.7%) and Eviny AS (38.2%) and Stord Municipality (2.1%).

Figure 1: Simplified overview



Sources: SKL, Scope

Financial overview

				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	44.6x	5.7x	108.3x	262.4x	178.5x	87.4x
Scope-adjusted debt/EBITDA	1.0x	10.9x	0.4x	Net Cash	Net Cash	Net Cash
Scope-adjusted funds from operations/debt	30%	-14%	244%	Net Cash	Net Cash	Net Cash
Scope-adjusted free operating cash flow/debt	-27%	-37%	217%	Net Cash	Net Cash	Net Cash
Scope-adjusted EBITDA in NOK m						
EBITDA	659	120	1,771	5,271	3,619	1,767
Scope-adjusted EBITDA	**659**	**120**	**1,771**	**5,271**	**3,619**	**1,767**
Funds from operations in NOK m						
Scope-adjusted EBITDA	659	120	1,771	5,271	3,619	1,767
less: (net) cash interest paid	-15	-21	-16	-20	-20	-20
less: cash tax paid per cash flow statement	-461	-283	-33	-965	-3,745	-2,839
add: dividends from associates	-	-	-	17	17	17
Other	12	-1	-2	-	-	-
Funds from operations (FFO)	**195**	**-185**	**1,720**	**4,303**	**-129**	**-1,075**
Free operating cash flow in NOK m						
Funds from operations	195	-185	1,720	4,303	-129	-1,075
Change in working capital	-101	-48	132	-1	-1	-1
less: capital expenditure (net)	-272	-258	-323	-250	-400	-450
Free operating cash flow (FOCF)	**-178**	**-491**	**1,529**	**4,052**	**-530**	**-1,526**
Net cash interest paid in NOK m						
Net cash interest per cash flow statement	-15	-21	-16	-20	-20	-20
Change in other items	-	-	-	-	-	-
Net cash interest paid	**-15**	**-21**	**-16**	**-20**	**-20**	**-20**
Scope-adjusted debt in NOK m						
Reported gross financial debt	832	1,368	919	621	621	618
less: cash and cash equivalents	-187	-66	-220	-1,252	-733	-636
add: pension adjustment	4	8	7	7	7	7
Other items	-	-	-	-	-	-
Scope-adjusted debt (SaD)	**649**	**1,310**	**706**	**-624**	**-105**	**-11**

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

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)

ESG profile supportive of market position, profitability, cash flow and access to liquidity

SKL is a pure-play producer of renewable hydro power. This constitutes a competitive advantage as the climate crisis is not only shaping environmental regulation and policy but also driving customers towards cleaner power.

The Norwegian utilities sector is subject to regulatory and reputational risks. This was evident in September 2022 when the government announced plans for a temporary[2] windfall tax on hydro power producers. The tax has not been implemented as of this report's publication, but we believe it will be implemented in some form, at the very least as a cap on net profit from generators to be more in line with 2021 results, lower than those in the 12 months to Q2 2022.

Considering the extraordinary circumstances and the temporary nature of these taxes, we do not consider this a shift in the regulatory environment. The regulatory environment has a stable history, something we foresee will continue. This stability is reflected through industry and market assessments.

[1] 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.
[2] Windfall tax will only last until end-2023.

Business risk profile: BBB-

Industry risk profile: BB

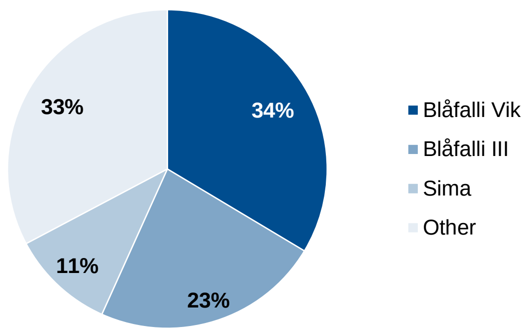
SKL is a pure-play power producer. We consider pure power generation to have high cyclicality and medium barriers to entry, which comes with a BB industry risk under our methodology (details here).

Small power generator with adept assets

SKL produces 2.5TWh of electricity a year, making it a small generator in Norway (Figure 3). However, size is not overly important in our assessments of the market position and credit quality of a power utility. This is because the company has high capacity utilisation and is favourably positioned with its hydropower assets at the front of the merit order system, with a low-cost profile. Large storage capacity and high installed capacity provide the Norwegian hydropower system with significant flexibility in the European context.

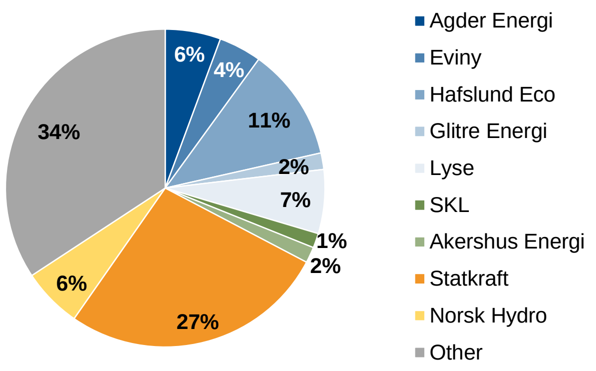
For SKL specifically, we note positively its high share of hydro reservoir capacity, at around 50% of its annual production. Some capacity also comes from natural meltwater from the Folgefonna glacier, which can compensate for periods of low precipitation.

Figure 2: Generating asset concentration, FY 2021



Sources: SKL, Scope

Figure 3: Adjusted market shares, Norwegian hydro power producers, FY 2021



Sources: SKL, Scope

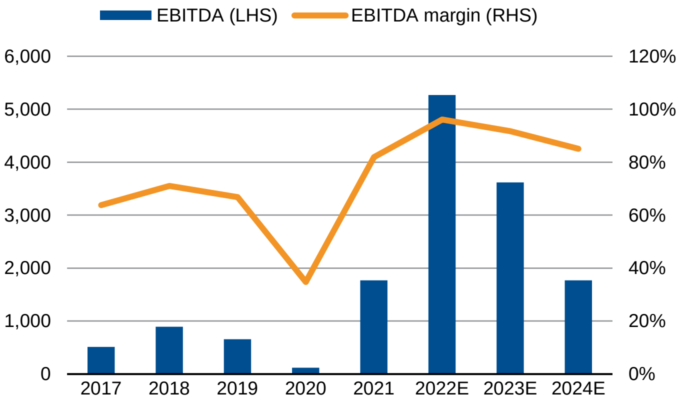
Geographical diversification is limited compared to large European power producers and some local peers. The company is largely concentrated in the western part of southern Norway. While its power could virtually be sold anywhere within the Nord Pool market, price differentiation can also occur regionally.

High asset concentration

SKL's diversification of its power generation portfolio is inadequate. This is because the largest hydropower plant produces around 30% of its energy yearly, and the largest three produce around 60% (Figure 2).

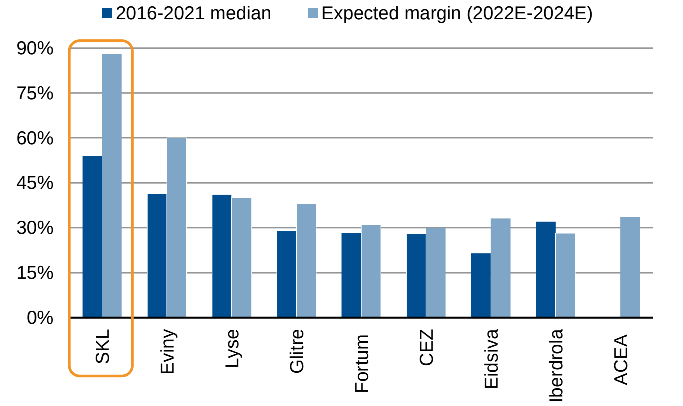
SKL has been seeking collaborations and strategic alliances. Recent examples are its offshore wind power project (Deep Offshore Wind) and hydrogen project (Hydrogen Solutions). Although these could increase diversification over time, they are not yet material enough to affect our current assessment.

Figure 4: Historical and expected profitability



Sources: SKL, Scope estimates

Figure 5: EBITDA margin peer comparison



Sources: SKL, Scope estimates

Strong profitability expected for the short to medium term

SKL's profitability margins have been very strong because its core activity of hydropower production is directly benefitting from the above-normal energy prices in the Nordics. This was exemplified by the YTD H1 2022 EBITDA margin of around 86% (around 65% in YTD H1 2021). Similarly, profitability is low when prices are low, as seen in 2020 when the reported EBITDA margin was around 35%. In the medium term, we expect higher Nordic prices to be the new norm. Consequently, we see SKL's profitability to increase towards 96% in 2022 before gradually normalising along with the power prices.

Less emphasis on lack of hedging for profitability assessment

SKL has a policy of not hedging future production. This previously constrained the business risk profile under the profitability assessment, but the lack of hedging is now less of a factor due to recent developments. From end-2021, the Nordic system price, used as a hedging benchmark, was decoupled from the spot price applied in the various Nordic regions. Thus, making it difficult to effectively hedge Nordic production. In addition, the elevated prices have caused liquidity issues from increasing margining deposits as well as unrealised losses on hedged positions. Further, the current energy crisis will cause volatility to rise into the medium term, regardless of hedge ratios. We therefore place less emphasis on this in our current assessment.

Financial risk profile: BBB+

The financial risk profile is also significantly impacted by this volatility. The 2020 year was a historical low point, with negative operating cash flow and weak financial credit ratios. This was followed by a good year in 2021 and 2022 has so far been exceptionally good. We expect 2022 year-end metrics to be even stronger due to above-normal Nordic power prices.

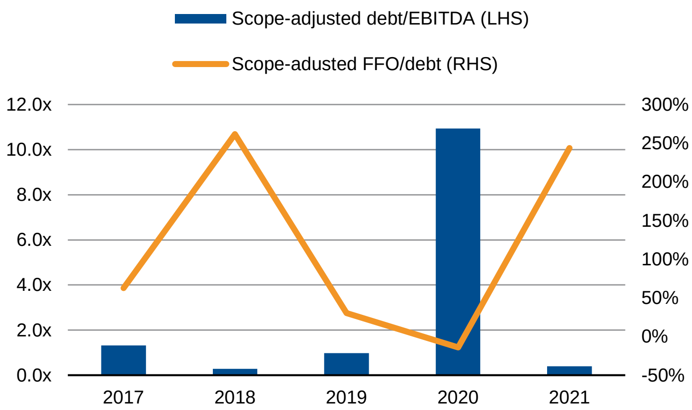
The main drivers behind our medium-term forecast and credit ratio expectations are:

- Elevated Nordic power prices into the medium term
- Annual production at close to maximum capacity
- Higher marginal tax rate due the proposed windfall tax
- Dividends on higher end of historical ratios
- Capex higher than historical average

Project conservative metrics into the medium term

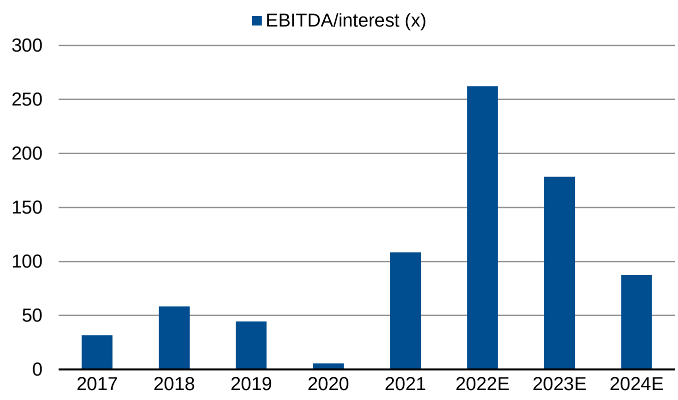
Despite expectations of higher taxes, dividends and capex, we still see the company moving towards net cash due to the record earnings in 2022. Consequently, we project both leverage and interest coverage to be very strong into the medium term (Figure 6-7). However, there are uncertainties due to the unhedged production, the looming tax changes and unstable Nordic power prices.

Figure 6: Leverage metrics[3]



Sources: SKL, Scope estimates

Figure 7: Interest coverage

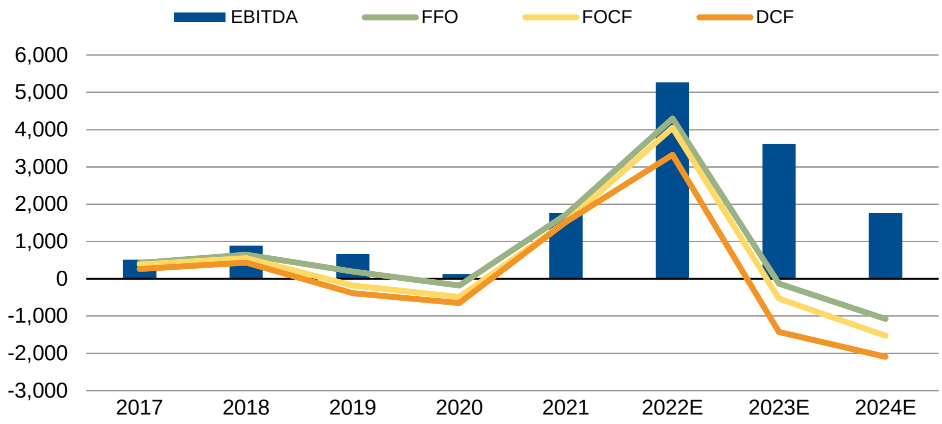


Sources: SKL, Scope estimates

Negative cash flows in 2023-24

Because of the timing of tax payments (one-year delay), we expect cash flows to become negative in 2023-24 as large tax payments for 2022-23 are made (Figure 8). However, with low debt levels and record earnings, SKL will likely be able to cover these payments through internal and external funding.

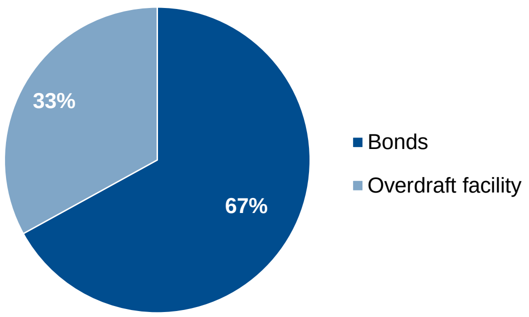
Figure 8: Cash flows



Sources: SKL, Scope estimates

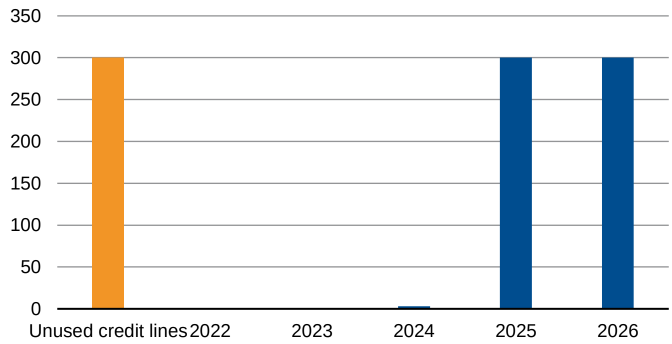
[3] Not presented for 2022-2024E as the company is expected to be net cash

Figure 9: Funding mix, H1 2022



Sources: SKL, Scope

Figure 10: Maturity profile, H1 2022



Sources: SKL, Scope

Adequate liquidity

Liquidity remains adequate. Funding mainly consists of senior unsecured debt (bonds) and an unutilised NOK 300m overdraft facility (Figure 9).

Driven by exceptional earnings, internal and external liquidity cover is forecast at over 2x into the medium term.

While some of the earnings were channelled into extraordinary dividends (October 2022), some were used to deleverage the already strong balance sheet through the recent repurchase of NOK 297m of a NOK 300m bond set to mature in 2024.

Balance in NOK m	2021	2022E	2023E
Unrestricted cash (t-1)	66	220	1,252
Open committed credit lines (t-1)	364	300	300
Free operating cash flow	1,529	4,052	-530
Short-term debt (t-1)	738	0	0
Coverage	**> 200%**	**> 200%**	**> 200%**

Supplementary rating drivers: +1 notch

No adjustment for financial policy

We have made no adjustment for financial policy, as this is already reflected in our financial risk profile assessment. We note that the company aims to keep an investment-grade profile; thus, management will always adapt capex plans against this goal. As power price volatility has had a huge impact on results, SKL aims to maintain a strong equity ratio and pursues other internal credit ratio targets to withstand these swings.

One-notch uplift for SKL's indirect majority municipal ownership

We anticipate medium capacity and willingness of the indirect municipal owners to provide support if needed, allowing a one-notch uplift on SKL's stand-alone credit rating, in line with our government-related entities methodology. Our assessment of the indirect majority municipal ownership of SKL is determined not by the stand-alone performance or credit quality of Eviny or Haugaland Kraft, but by their capacity and willingness to provide support if needed.

Long-term debt rating

Senior unsecured debt rating: BBB+

The rating on senior unsecured debt has been upgraded to BBB+ from BBB, the same level as the issuer rating.

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