Haugaland Kraft AS
Norway, Utilities

STABLE
BBB+

Corporate profile

Haugaland Kraft is a Norwegian utility company with operations across several segments, including hydropower generation, transmission and distribution of energy, and telecommunications networks. The company has a regional focus with most operations in the western part of Southern Norway. Haugaland Kraft is owned by seven municipalities (79.4%) and four utility cooperatives (20.6%) located in its service territory. The hydropower generation business operates within Sunnhordland Kraftlag (SKL), an independent company in which Haugaland Kraft owns a 59.7% stake (fully consolidated into Haugaland Kraft's financial figures).

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	51.9x	18.3x	42.3x	24.1x
Scope-adjusted debt (SaD)/EBITDA)	1.3x	4.0x	1.5x	3.0x
Scope-adjusted funds from operations/SaD	35%	16%	62%	14%
Free operating cash flow/SaD	-14.1%	-22.9%	17.5%	-20.3%

Rating rationale

Scope has assigned a BBB+/Stable issuer rating on Haugaland Kraft along with a BBB+ senior unsecured debt rating and an S-2 short-term rating.

The issuer rating reflects stand-alone credit quality of BBB and a one-notch uplift based on our assessment of parent support. The uplift is driven by the anticipated capacity and willingness of Norwegian municipal owners to provide support and was assessed in accordance with our Government Related Entities Methodology.

Regarding Haugaland Kraft's business risk profile, we note positively its diversification into various segments, especially the combination of robust infrastructure segments, such as monopolistic power distribution and fibre broadband services. In addition, the company is exposed to profitable, environmentally friendly, low-cost hydropower production via its 59.7% ownership stake in Sunnhordland Kraftlag AS. Although SKL adds segment diversification, it also indirectly adds volatility through its high electricity price exposure from its fully unhedged production output. Further business risk elements include limited geographical outreach in selected segments and indirect high asset concentration risk via SKL.

The financial risk profile can be described as relatively conservative historically, although FY 2020 consolidated figures were negatively impacted by weak results at SKL. Having a significant equity ratio and low leverage gives the company a buffer to handle this volatility. This is also part of its strategy, given the inherent indirect volatility risk via SKL that is due to the policy of unhedged prices. Although FY 2020 showed negative free operating cash flow (FOCF) and weak financial credit ratios, we expect 2021 to return to more conservative levels given the significantly improved market prices achieved this year. Still, going forward, we anticipate that the company will increase its capex (compared to levels seen in recent historical years) and maintain its dividend policy.

Ratings & Outlook

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

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Related Methodologies

European Utility Methodology

Corporate Rating Methodology

Government Related Entities Methodology

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Based on our estimates and assumptions, this would increase its average leverage ratio to a range of 3x-4x. We deem liquidity to be adequate and note that the company has more than enough cash and back-up credit facilities to handle its well-distributed debt maturity schedule.

We have made no adjustment for financial policy. We note that the company aims to keep an investment-grade profile and maintain a strong overall FRP. It analyses capex plans against this goal before making any commitments. We see dividend pay-outs to owners as very predictable, with an established policy of distributing 60% of results during the last three years.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that Haugaland Kraft will remain a diversified utility with grid, power sales and fibre broadband operations as well as a majority owner in hydropower generation via SKL. It assumes that the company will maintain a conservative capital structure and a high equity ratio, paired with prudent investment and growth ambitions. It also assumes the combined group of Norwegian municipalities will continue to be a majority shareholder in Haugaland Kraft.

A positive action could be warranted if free operating cash flow was used to service debt repayment, resulting in sustained, conservative credit metrics. This could be exemplified by Scope-adjusted debt/EBITDA of around (or below) 2.5x on a sustained basis. A positive action could also occur in the longer term if we saw a larger contribution from the more stable infrastructure business, leading to lower volatility and an improved business risk profile.

A negative rating action is possible if the company’s financial risk profile weakened due to lower wholesale prices or debt-financed transactions or investments, resulting in leverage above 4.0x for a prolonged period. The loss of its status as a government related entity following a change in ownership could trigger a downgrade as well.

Rating drivers

Positive rating drivers	Negative rating drivers
• Diversified business model given exposure to monopolistic power distribution, fibre broadband, power generation and power retail sales, among other areas • Long-term, supportive, committed municipal owners, justifying an uplift to the stand-alone rating in accordance our GRE methodology • Intention and a proven history of maintaining a conservative financial risk profile	• Relatively large indirect exposure to volatility in power prices from unhedged production output via SKL • Ambitious investment projects continue to put pressure on FOCF generation • Stated ambition to complete more structural transactions creates an evolving organisational structure with some uncertainty regarding future business risk

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Cash flow used to service debt rather than capex, resulting in sustained Scope-adjusted debt/EBITDA of around (or below) 2.5x • Increasing contribution from more stable infrastructure business, which could lead to lower volatility or an improved business risk profile	• Weaker financial risk profile, exemplified by Scope-adjusted debt/EBITDA of above 4x on a sustained basis • Loss of GRE status due to a change in ownership

Financial overview

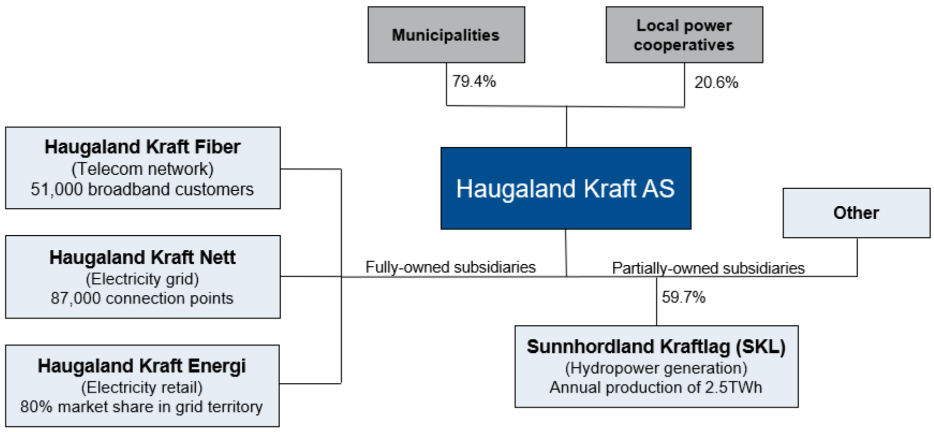
			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	51.9x	18.3x	42.3x	24.1x
SaD/Scope-adjusted EBITDA	1.3x	4.0x	1.5x	3.0x
Scope-adjusted funds from operations/SaD	35%	16%	62%	14%
Free operating cash flow/SaD	-14.1%	-22.9%	17.5%	-20.3%
EBITDA in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBIT	1,046	382	1,378	827
add: depreciation	248	286	300	320
Scope-adjusted EBITDA	**1,293**	**667**	**1,678**	**1,147**
Scope-adjusted funds from operations in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	1,293	667	1,678	1,147
less: (net) cash interest as per cash flow statement	-25	-36	-40	-48
less: cash tax paid as per cash flow statement	-506	-328	-101	-602
Other items	-190	122	0	0
Scope-adjusted funds from operations	**573**	**425**	**1,537**	**497**
Scope-adjusted debt in NOK m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	2,024	2,725	2,537	3,527
Cash, cash equivalents	-453	-134	-136	-94
Restricted cash	63	63	63	63
add: pension adjustments	-	-	-	-
add: other	0	0	0	0
SaD	**1,634**	**2,655**	**2,463**	**3,496**

Business risk profile

Industry risk profile

In accordance with Scope's rating methodology for utilities, we have assessed each of the company's segments separately, taking their different characteristics into account. Haugaland Kraft's normalised EBITDA contribution by segment is as follows: power generation (about 53%), grid (about 27%), retail sales (about 5%) and broadband (about 15%), Scope's overall blended industry risk assessment is BBB+. In our view, the general European power generation market is characterised by highly cyclical features and medium barriers to entry, while the regulated distribution business has low cyclicality and high barriers to entry. We consider cyclicality in telecoms and fibre-cable services to be low, with utility-like demand characteristics. Barriers to entry vary somewhat across the different sub-industries, but overall we deem cyclicality to be medium, as barriers to entry can be lower when competition from companies that rent network capacity is included. Finally, there is the company's exposure to retail power sales, which are characterised by low cyclicality and low barriers to entry.

Figure 1: Simplified organisational structure



Source: Company

Ownership stake in SKL, a small power generator in Norway

Haugaland Kraft owns approximately 60% of SKL, which has production of about 2.5 TWh. This means it is considered a relatively small power generator in Norway (less than a 2% share of total production). Still, we highlight that size is not overly important when assessing the market position and credit quality of a power utility. Moreover, the company has high capacity utilisation and is favourably positioned with its hydropower assets in the front of the merit order system, with a low-cost profile. For SKL specifically, we also note positively that it has a relatively high share of hydropower reservoir capacity, at around 50% of its annual production.

Grid and fibre broadband provide stability

Haugaland Kraft's grid business contributes around 25%-30% of EBITDA, serving 90,000 customers, with most private customers in its service territory in Western Norway. Given that this monopoly business allows timely cost coverage, it is regarded as a robust source of cash flow over time. Tariffs are determined retrospectively, guaranteeing sufficient cost coverage.

Market shares in the company's two other main business segments, retail power sales and broadband, are considered small. In retail power it has a customer base of around 80% of its monopolistic network service territory, while the telecoms/broadband business has around 50,000 customers.

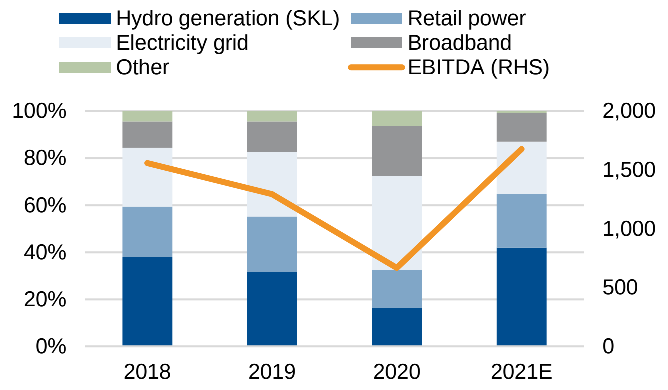
Positive segment diversification but limited geographical outreach

We consider segment diversification to be relatively good. Exposure to generation, grid, broadband and power supply is coupled with low dependence on any single customer. However, geographical diversification is limited to the western part of Southern Norway.

Moreover, we see some risks arising from asset concentration due to relatively high dependence on SKL's largest hydropower plants in the generation portfolio[1].

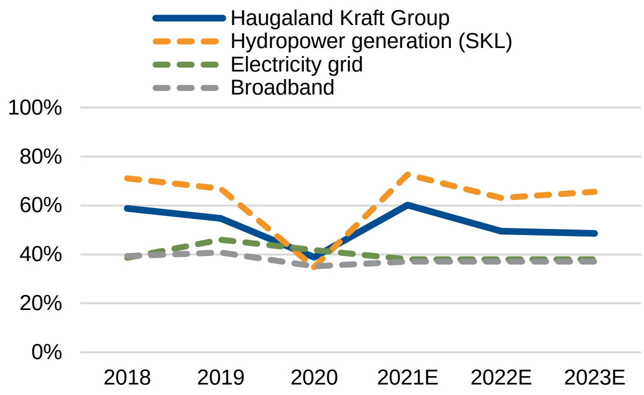
The company is also engaged as a service provider within solar, electrical charging, alarm and lighting products. These elements are only a small part of our rating assessment, but they are a valuable tool for cross-selling and customer loyalty. Recent participation in establishing Deep Wind Offshore is largely seen as a vehicle for early value creation rather than large investment plans. This suggests that Haugaland Kraft is likely to reduce shareholding interests if/when growth investments become too large.

Figure 2: Segments revenues (LHS in % of total) and EBITDA in NOK m (RHS)



Source: Company, Scope

Figure 3: Segment and group EBITDA margin over time



Source: Company, Scope

Strong, but volatile operating profitability

Fluctuating factors stemming from electricity generation volumes and achievable prices are present when assessing the overall profitability volatility of the Haugaland Kraft group. In particular, we highlight that SKL does not hedge any volumes or have any long-term contracts with industrial partners, making its archived price volatility higher than most Norwegian peers.

As the main owner of SKL, Haugaland Kraft supports this strategy of no power price hedging because it believes it will achieve higher returns over time. To endure the higher volatility that it entails, Haugaland Kraft has committed itself to having a strong balance sheet and a high equity ratio.

Over time, the group's EBITDA margin is helped by its large exposure to low-cost hydropower generation through its stake in SKL. By contrast, the contribution from low-margin retail power sales weighs on the group's margins. Yet compared to peers, Haugaland Kraft is still among the top Norwegian utility companies in terms of profitability.

[1] *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

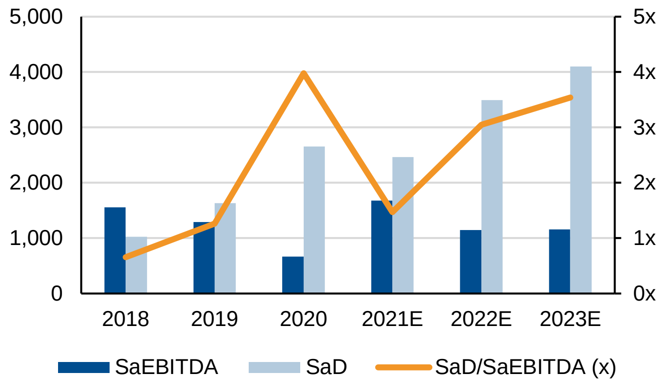
SKL is fully consolidated into Haugaland Kraft, but 40.6% of SKL's share capital belongs to BKK and Stord Municipality. As a result, the true/underlying exposure and volatility in credit metrics is lower than what appears below, and so these metrics should be interpreted with this fact in mind. As the majority owner, Haugland Kraft has total control over SKL's dividend pay-outs, although the policy of a 60% ratio they have followed historically is assumed to continue.

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

While FY 2020 showed negative operating cash flow and weak financial credit ratios, the group's financial risk profile can be described as relatively conservative historically. Having a significant equity ratio and low leverage gives the company a buffer. It is also part of its strategy, given the inherent indirect volatility risk via SKL, which is due to the policy of unhedged power prices.

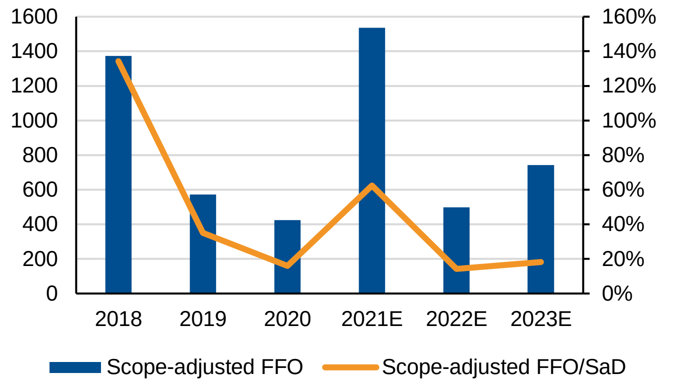
In terms of debt adjustment and calculating credit metrics, we have made limited adjustments to reported numbers. Notably, we have not made any adjustments for pensions as the company has a surplus of pension assets versus liabilities.

Figure 4: EBITDA (NOK m, LHS) and leverage (RHS)



Source: Company, Scope

Figure 5: FFO (NOK m, LHS) and FFO/SaD (RHS)



Source: Company, Scope

Leverage expected to climb in 2022 and 2023

Our forecast estimates indicate a weakening of Haugaland Kraft's credit metrics going forward, driven primarily by higher investments. We expect leverage to stabilise in the 3x-4x range, while interest cover is expected to remain very solid.

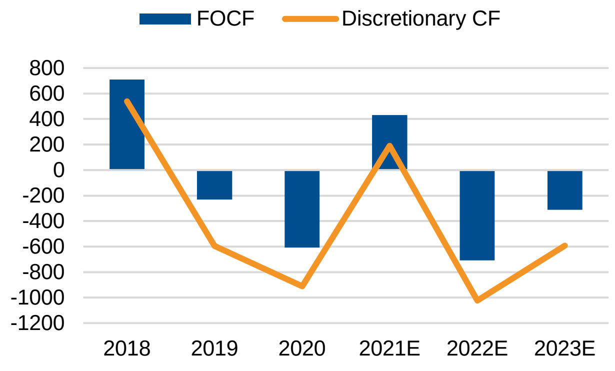
The main drivers behind our forecast and credit ratio expectations are within hydropower production (SKL), the grid segment and fibre broadband. In hydropower generation, we expect SKL to deliver exceptionally good results in 2021 following record-high electricity prices in Norway's NO2 zone. FY 2022 and FY 2023 revenues are expected to be lower due to a decline in power prices that can already be seen in the forward market today, indicating a gradual return to relatively normal price levels. Revenues and EBITDA from the grid segment are projected to be much more stable, while the broadband business is set to experience double-digit growth in 2021E and mid-single-digit growth (including Afiber) in the medium term.

Mostly negative FOCF over time due to high investments

Most of the capex increases expected in the next few years (until 2024) are related to continued, high grid investments as well as growth ambitions in broadband and power generation. We expect the annual investment level to increase by about 30% p.a. on average during the next three years versus the levels seen during 2018-20. Most of this growth is within the service territory, except for the broadband business, which is also through Afiber.

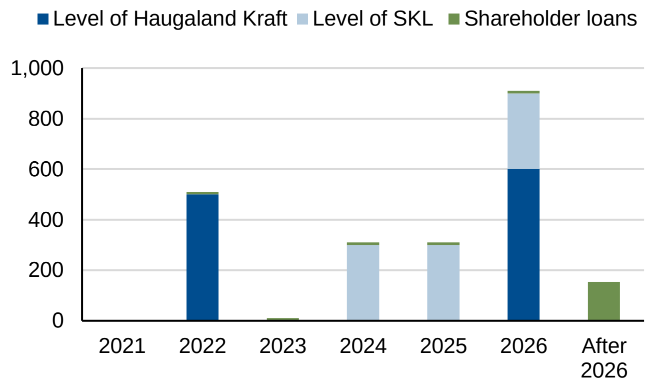
Cash flow volatility is driven by exposure to SKL, while grid and fibre provide much more stability. We have judged cash flow generation over time and looked at long-term, normalised levels adjusted for volatility risk. In addition, we have judged the ability to generate positive FOCF over time. Looking at recent history and the medium-term forecast in Figure 6, we see that FOCF tends to be negative. With respect to the numbers behind our discretionary cash flow expectations, we assume annual dividends paid to owners at 60% of net income.

Figure 6: FOCF and discretionary cash flow (NOK m)



Source: Company, Scope

Figure 7: Debt maturity (NOK m)



Source: Company, Scope

SKL issues bonds separately although it is consolidated in Haugaland

At H1 2021, the company had NOK 0.5bn in cash, which is in line with the first material maturing debt in 2022. The company also has a NOK 1.1bn overdraft line which it can use. Haugaland Kraft's financial debt is primarily bonds. The NOK 500m maturity in 2022 and NOK 600m of the maturity in 2026 are issued by Haugaland Kraft itself. The remaining NOK 900m is issued separately by SKL on a stand-alone basis. Haugaland Kraft also had a NOK 206m shareholder loan at YE 2020, which it will start to pay down in 2022 in equal instalments over 20 years.

Supplementary rating drivers

Prudent financial policy

We have made no adjustment for financial policy. We note that 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 to owners as very predictable, with a well-established policy of distributing 60% of results during the last three years.

Government related entity with one-notch uplift

Haugaland Kraft is 79.4% owned by Norwegian municipalities, while the remaining 20.6% is owned by four 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 or full 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 medium, which includes an evaluation of strategic importance, ease of substitution and default implications.

Governance and structure

Governance procedures in Haugaland Kraft's framework are considered good. We view the company's organisational structure, including its majority ownership of SKL, as evolving. It has increased its stake in SKL on several occasions and seems to look out for further structural transactions.

We also acknowledge the group's well-integrated ESG framework and ambitions, including its publication of green financing reports.

Long-term and short-term debt ratings

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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