21 November 2023 Corporates

Vardar AS
Kingdom of Norway, Utilities

SCOPE BBB+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA interest cover	5.9x	24.8x	7.5x	5.8x
Scope-adjusted debt/EBITDA	4.1x	1.6x	2.2x	2.5x
Scope-adjusted funds from operations/debt	20%	51%	20%	19%
Scope-adjusted free operating cash flow/debt	20%	48%	19%	18%

Rating rationale

The rating reflects a standalone credit assessment of BBB and a one-notch uplift based on our assessment of the company's status as a government-related entity.

The standalone credit assessment of BBB reflects the main exposure to low-cost, environmentally friendly hydropower generation (positive ESG factor) from a 2/7 share in the Usta and Nes hydropower plants and a 12.91% ownership stake in Å Energi AS. It also reflects a good financial risk profile, with Scope-adjusted leverage of 2.0x-2.5x and strong internal financing capacity. The assessment is constrained by the small scale and high asset concentration of Vardar's consolidated businesses versus larger peers, as well as moderate geographical diversification. It is also held back by the cyclical operating environment with exposure to volatile power prices.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation of supportive power prices in southern Norway continuing over the next few years, albeit at lower levels than in 2022 and H1 2023. It further reflects our view that Vardar will maintain a leverage (Scope-adjusted debt/EBITDA) between 2.0x and 2.5x over 2023-2025. This view is underpinned by the company's willingness (as per its financial policy) and ability to keep net debt stable by adapting discretionary cash outflows to operating results. The view also incorporates Å Energi's dividend policy with the payout in year (t) being based on the result in year (t-2), which supports visibility on Vardar's dividend income through 2025. Lastly, Scope expects the company to maintain its core assets, including the Usta and Nes power plants and its stake in Å Energi.

A positive rating action could be warranted if stronger credit metrics were sustained, as exemplified by a Scope-adjusted debt/EBITDA of around 1.0x or below. This is seen as remote given the company's intention to keep reported net debt near the current level.

A negative rating action could be triggered if Scope-adjusted debt/EBITDA reached about 3.0x on a sustained basis. This could be driven by lower-than-expected power prices, an adverse change in financial policy, and/or a significant deterioration of Å Energi's credit profile (and thereby its dividend capacity). The loss of government-related entity status (deemed remote) could also result in ratings pressure.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
21 Nov 2023	Initial rating	BBB+/Stable

Ratings & Outlook

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

Analysts

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Related Methodologies

General Corporate Rating Methodology; October 2023

European Utilities Rating Methodology; March 2023

Government Related Entities Methodology; July 2023

Related Research

European utilities: continued electricity price hedging promises producer gain, consumer pain, Apr 2023

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
• Low-cost, environmentally friendly hydropower and wind power generation (positive ESG factor) • Robust and recurring dividend income from a 12.91% ownership stake in Å Energi • Good financial risk profile with Scope-adjusted leverage of 2.0x-2.5x and strong internal financing capacity • Low mandatory maintenance capex, providing financial flexibility • Long-term committed municipal owners with capacity and willingness to provide potential parent support	• Exposure to volatile power prices for unhedged power generation volumes • Small scale and high asset concentration in consolidated hydropower, wind power and district heating businesses • Moderate geographical diversification with most direct and indirect power generation located in southern Norway • Investments going mainly into early-stage growth companies, involving more risk than mature assets

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA sustained at around 1.0x or lower	• Scope-adjusted debt/EBITDA sustained around 3.0x • Loss of GRE status (remote)

Corporate profile

Vardar is a Norwegian utility company owned by 19 municipalities within the former counties of Buskerud and Akershus. The company is mainly exposed to hydropower generation in southern Norway through its 2/7 share in the Usta and Nes[1] power plants and recurring dividend income from a 12.91% ownership stake in Å Energi[2]. It is also involved in district heating, wind power and solar activities.

[1] Both plants are operated by Hafslund (which owns 4/7), and Vardar's share of annual mean production is around 0.7 TWh.

[2] Å Energi is a fully integrated utility and Norway's third largest hydropower producer, with mean annual production of 11.3 TWh. It is also active in distribution grid operations and energy retail. Å Energi was established in November 2022 through a merger of Agder Energi AS and Glitre Energi AS. Prior to the merger, Glitre Energi was owned 50/50 by Vardar and Drammen municipality.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA interest cover	2.2x	5.9x	24.8x	7.5x	5.8x	6.1x
Scope-adjusted debt/EBITDA	10.7x	4.1x	1.6x	2.2x	2.5x	2.2x
Scope-adjusted funds from operations/debt	2%	20%	51%	20%	19%	24%
Scope-adjusted free operating cash flow/debt	1%	20%	48%	19%	18%	22%
Liquidity	> 200%	> 200%	> 200%	> 200%	> 200%	123%
Scope-adjusted EBITDA in NOK m						
EBITDA	31	235	641	323	332	328
Dividends received from Glitre/Å Energi	95	66	96	207	140	210
Scope-adjusted EBITDA	**125**	**300**	**738**	**530**	**471**	**538**
Funds from operations in NOK m						
Scope-adjusted EBITDA	125	300	738	530	471	538
less: (net) cash interest paid	(59)	(53)	(35)	(68)	(77)	(85)
less: cash tax paid per cash flow statement	(37)	(15)	(93)	(224)	(164)	(165)
less: pension interest	(2)	(2)	(2)	(2)	(2)	(2)
Other items	3	16	(0)	-	-	-
Funds from operations (FFO)	**29**	**247**	**608**	**236**	**227**	**285**
Free operating cash flow in NOK m						
Scope-adjusted FFO	29	247	608	236	227	285
Change in working capital	8	26	(24)	-	-	-
less: capital expenditure (net)	(19)	(16)	(16)	(10)	(20)	(20)
Lease amortisation	(1)	(2)	(2)	(2)	(2)	(2)
Free operating cash flow (FOCF)	**16**	**255**	**567**	**225**	**206**	**263**
Net cash interest paid in NOK m						
Net cash interest per cash flow statement	28	29	5	35	37	48
Interest expense on pensions	2	2	2	2	2	2
Interest component of operating leases	1	1	1	1	1	1
Interest paid on subordinated loan from Viken	25	18	21	33	40	37
Net cash interest paid	**57**	**51**	**30**	**71**	**81**	**88**
Scope-adjusted debt in NOK m						
Reported gross financial debt	817	756	858	858	858	818
less: cash and cash equivalents	(10)	(109)	(270)	(284)	(288)	(221)
add: non-accessible cash	10	68	63	63	63	63
add: pension adjustment	17	21	26	26	26	26
Shareholder loan from Viken municipality	508	508	508	508	508	508
Scope-adjusted debt	**1,342**	**1,244**	**1,185**	**1,171**	**1,166**	**1,194**

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

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)

Business model built around sustainable energy generation

Vardar's business model is focused on sustainability as it is mainly exposed to the production of clean hydroelectric power through directly and indirectly owned hydropower plants. As a result, the company holds a favourable position in the EU taxonomy. This should support future cash flow generation and reduce the risk of headwinds from regulation and political interference relating to sustainability matters. In addition, its exposure to hydropower generation (direct and indirect) and electricity distribution (indirect only) guarantees its continued status as a GRE.

Investments focused on reducing greenhouse gas emissions

Vardar focuses its growth investments on sustainable areas, including wind power and solar, as well as other areas supporting its overall sustainability target of contributing to reduced greenhouse gas emissions.

No governance issues

Vardar applies governance principles as recommended by Norwegian market standards. No negative credit-relevant factors pertaining to corporate governance were observed.

[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-

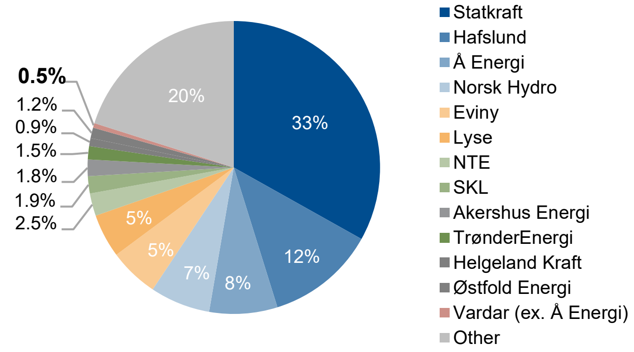
Main exposure to volatile but low-cost hydropower generation

Vardar's business risk profile reflects its main exposure to low-cost and environmentally friendly hydropower generation, which is supplemented by wind power and district heating activities. The assessment is constrained by the small scale and high asset concentration of directly owned generation activities, but we see this as partially balanced by the company's 12.91% ownership in Å Energi.

Ownership in Å Energi

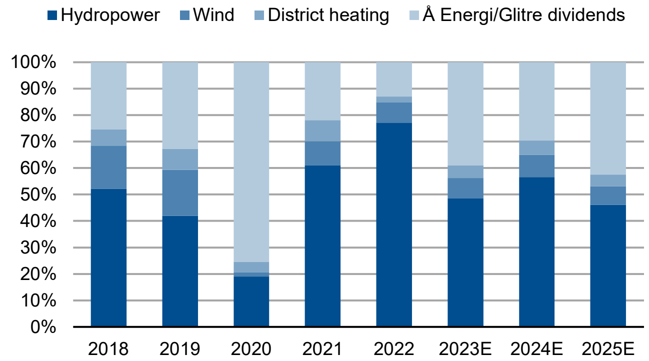
Recurring dividend income from Å Energi is expected to comprise a large share of operating cash flow, underpinned by Å Energi's strong credit profile (rated A-/Positive by Scope) and dividend policy of paying out 70% of results over time. We also view the joint ownership agreement with Drammen municipality positively, which enables Vardar to independently veto against changes to Å Energi's dividend policy and core business composition.

Figure 1: Normalised market shares in Norwegian hydropower generation



Source: NVE, Scope

Figure 2: Estimated split of Scope-adjusted EBITDA by segment



Source: Vardar, Scope (estimates)

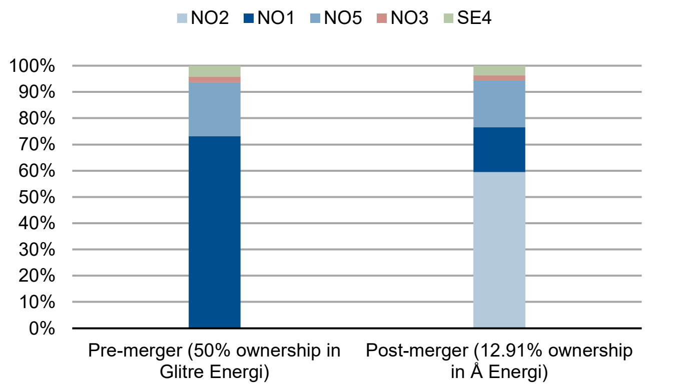
Small scale but strong position in merit order system

Vardar's directly and indirectly owned hydropower generation is favourably positioned in the merit order system due to low marginal production costs, which is more important than volumes for the market position of a power utility. The Usta and Nes power plants and Å Energi both have a high share of water reservoir capacity of around 55% of mean annual output. This is viewed as a credit-positive aspect since it provides flexibility to provide electricity when supply is constrained, such as during peak-load hours or periods with limited output from intermittent energy sources. It also reduces the exposure to volume risk in dry hydrological years compared to peers with mainly run-of-river power plants.

Moderate diversification

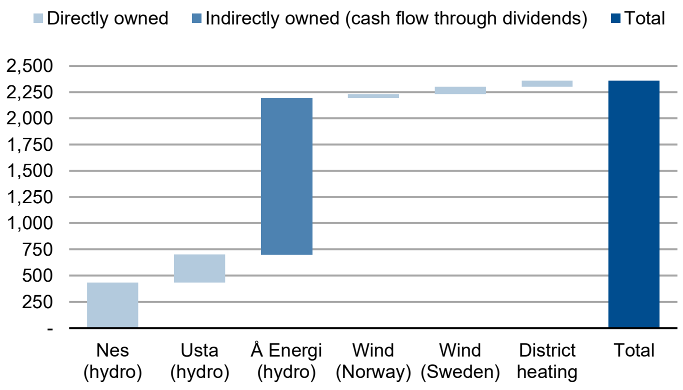
Overall diversification is moderate. The company's income streams from district heating and wind power generation (10%-15% of Scope-adjusted EBITDA) help mitigate part of the high concentration of consolidated energy generation on the Usta and Nes power plants. In addition, diversification benefits from robust dividend income provided by the ownership in Å Energi. These dividends reflect cash flow generated by a more diversified portfolio of 73 hydropower plants, as well as power distribution and energy retail activities. In terms of pricing risk, the company is mainly present in southern Norway within the NO1, NO2 and NO5 bidding zones, where power prices exhibit a strong correlation. The concentration in bidding zones with correlated prices is considered to be partially mitigated by interconnectors to other countries, including those to the UK and continental Europe from the NO2 bidding zone, as this gives southern Norway more exposure to electricity prices in other markets.

Figure 3: Estimated exposure of direct and indirect power generation by bidding zone, based on mean annual output



Source: Vardar, Scope

Figure 4: Directly and indirectly owned energy generation based on mean annual output, Vardar's share (GWh)

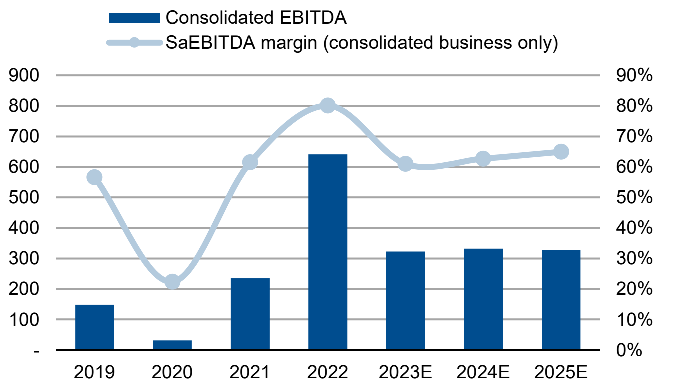


Source: Vardar, Scope

Above-average profitability and efficiency versus European peers

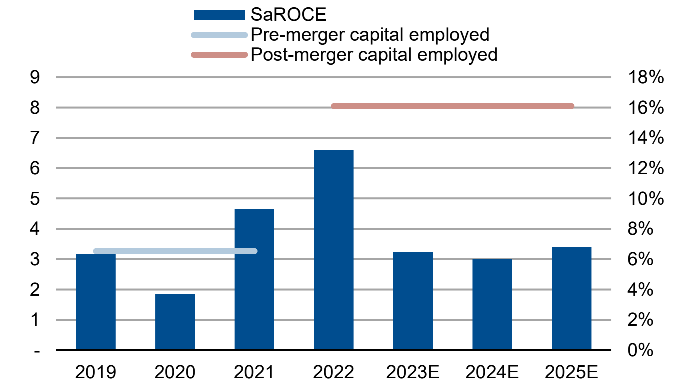
Profitability and efficiency are strong factors in Vardar's business risk profile, driven by low-cost hydropower and wind power generation. The consolidated group EBITDA margin is expected to remain at 60%-65%, with relatively low volatility due to a low absolute cost base, which is volume-dependent to some extent. Scope-adjusted return on capital employed is more volatile as there is no revenue component, illustrating the exposure of absolute EBITDA to achieved power prices. There was a transactional impact on capital employed from the merger of Glitre Energi and Agder Energi in November 2022, as figure 6 illustrates. We have accounted for this when assessing the level versus peers with more depreciated balance sheets.

Figure 5: Consolidated EBITDA (NOK m, LHS) and Scope-adjusted EBITDA margin (RHS) development



Source: Vardar, Scope (estimates)

Figure 6: Scope-adjusted ROCE (RHS) and comparison of pre- and post-merger capital employed (NOK bn, LHS)



Source: Vardar, Scope (estimates)

Financial risk profile: BBB+

Good financial risk profile supports the rating

The financial risk profile supports the company's standalone credit assessment. Overall, the financial profile reflects manageable indebtedness and strong free operating cash flow. Paired with low mandatory capex, this results in good financial flexibility.

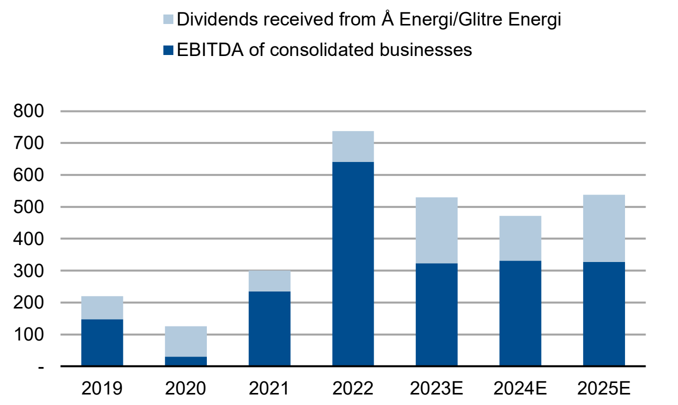
High visibility of forecasted dividend income from Å Energi

We note positively the two-year time lag in Å Energi's payout policy, with the dividend paid in year (t) being based on the result in year (t-2) – a dynamic that makes Vardar's credit metrics less correlated with power prices in a given year. It also supports visibility of forecasted dividend income through 2025.

Adjustments

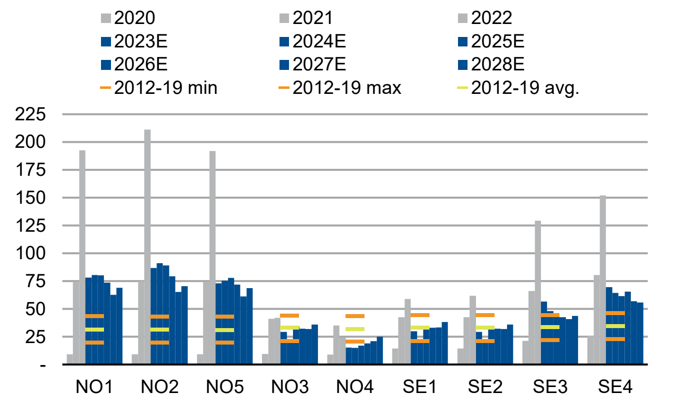
In terms of adjustments and the calculation of credit metrics, Scope-adjusted EBITDA is adjusted for recurring dividends received from Å Energi. In addition, Scope-adjusted debt fully accounts for the subordinated loan of NOK 508m from Viken County municipality. The loan is subordinated to other outstanding debt and operating costs, but does not qualify as a hybrid debt position as it has a determined maturity in 2031, no defined interest deferral and no conversion rights or mandatory replacement.

Figure 7: Scope-adjusted EBITDA development, NOK m



Source: Vardar, Scope (estimates)

Figure 8: Statnett's simulated power prices for 2023-28 versus historical levels, EUR/MWh (not Scope's forecast)



Source: Nordpool, Statnett's 2023-28 short-term market analysis, Scope

Main assumptions

The rating case assumes continued higher-than-historical power prices of around EUR 70/MWh in southern Norway (the NO1, NO2 and NO5 bidding zones), which compares to a historical average of about EUR 30/MWh over 2012-2019. We also note indications from recent analysis by various bodies, including Statnett (Figure 8), that the pricing environment is likely to remain supportive beyond 2025. In addition, we assume:

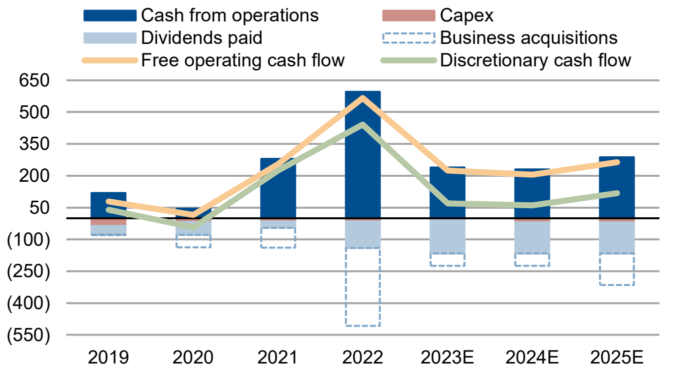
- Hydropower generation in line with annual mean output and 65 GWh per annum available for purchase on secondary concession power rights
- Dividends[4] from Å Energi of NOK 140m in 2024 and around NOK 210m in 2025
- Yearly EBITDA contributions from district heating and wind power generation of NOK 25m and NOK 40m respectively
- Capex of NOK 10m-20m p.a.
- Discretionary spending to be adapted to the level of free operating cash flow, leading to a stable net debt position
- No dividends from associated companies (e.g. Zephyr and Solcellespesialisten)

[4] Dividend forecasts are based on the estimates from our coverage of Å Energi (A-/Positive), reflecting: i) the dividend policy with a payout ratio of 70%, ii) the reported 2022 result for the 2024 dividend, and iii) Scope's expectation for the full-year 2023 result for the 2025 dividend.

Strong internal financing capacity, supported by low mandatory capex

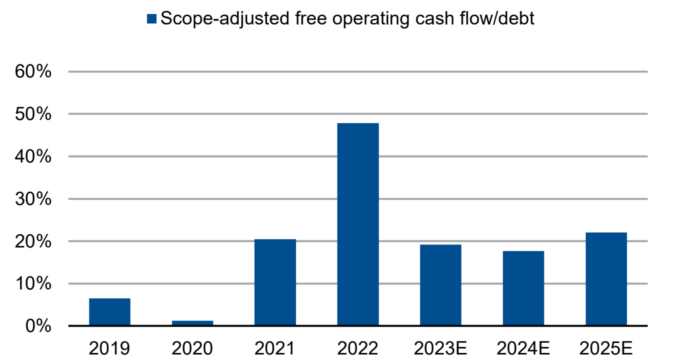
Scope-adjusted EBITDA is expected to be between NOK 470m-540m over 2023-2025, including yearly dividends of NOK 140m-210m from Å Energi. This should support continued positive free operating cash flow even in a less favourable pricing environment, due to low mandatory capex of only NOK 10m-20m per year. With the Scope-adjusted free operating cash flow/debt ratio expected to stay around 20%, we consider internal financing capacity to be a strong element in the financial risk profile.

Figure 9: Cash flow profile[5], NOK m



Source: Vardar, Scope (estimates)

Figure 10: Internal financing capacity



Source: Vardar, Scope (estimates)

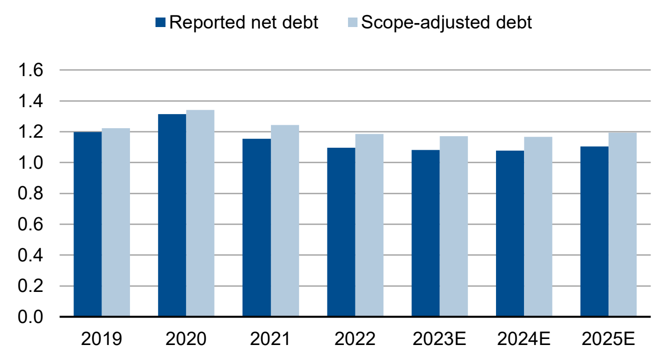
Net debt expected to remain unchanged

The company's high deleveraging capacity in the absence of dividend payouts and growth investments is viewed positively as it provides financial planning flexibility, which enables Vardar to adapt its level of cash outflows if needed. We expect the company will use its financial flexibility to keep net debt stable around the current level of NOK 1.1bn and thus keep its Scope-adjusted debt around NOK 1.2bn.

Expected leverage of 2.0x-2.5x but subject to power prices and net debt assumption

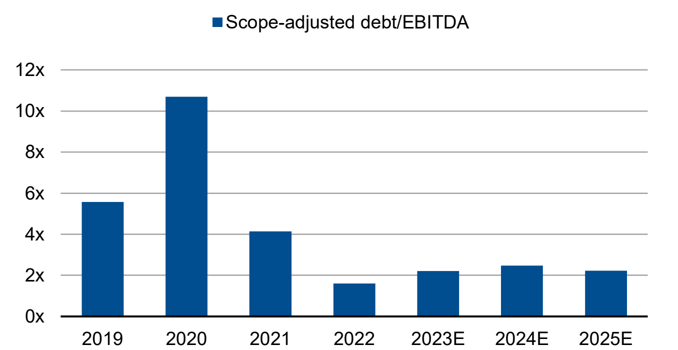
We expect Vardar's leverage – as measured by Scope-adjusted debt/EBITDA – to stay around 2.0x-2.5x throughout 2023-25. Dividends from Å Energi are expected to comprise 30%-40% of Scope-adjusted EBITDA over the coming years. As a result, Vardar's leverage is comparatively less exposed to taxation than that of other Norwegian utilities with a larger share of directly owned hydropower plants, a factor we considered in our peer comparisons.

Figure 11: Indebtedness, NOK bn



Source: Vardar, Scope (estimates)

Figure 12: Leverage development



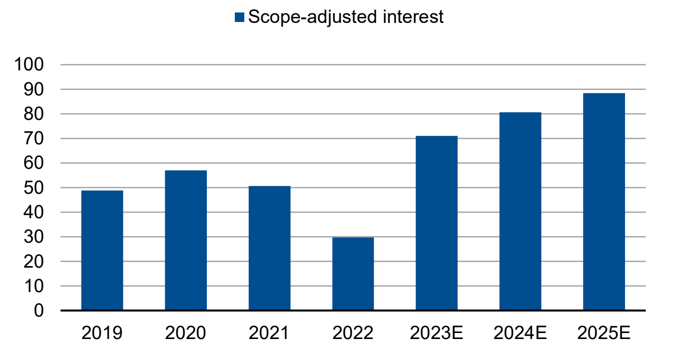
Source: Vardar, Scope (estimates)

[5] Dividends paid excludes an extraordinary dividend payout of NOK 700m in 2019 relating to the sale of the 77% stake in Nelja Energia.

Good debt protection

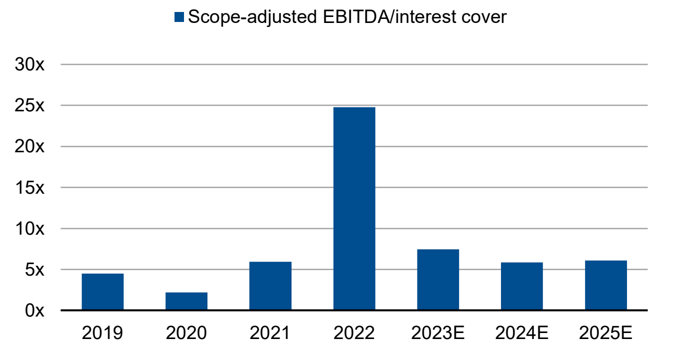
Debt protection metrics – as measured by Scope-adjusted EBITDA interest cover – are expected to stay at levels of around 6.5x. This expectation incorporates higher interest costs going forward as two thirds of outstanding debt is exposed to floating rates. Given the company's goal of maintaining a stable net debt position, we do not expect any external financing needs over the next few years besides refinancing.

Figure 13: Development of net interest paid, NOK m



Source: Vardar, Scope (estimates)

Figure 14: Development of debt protection



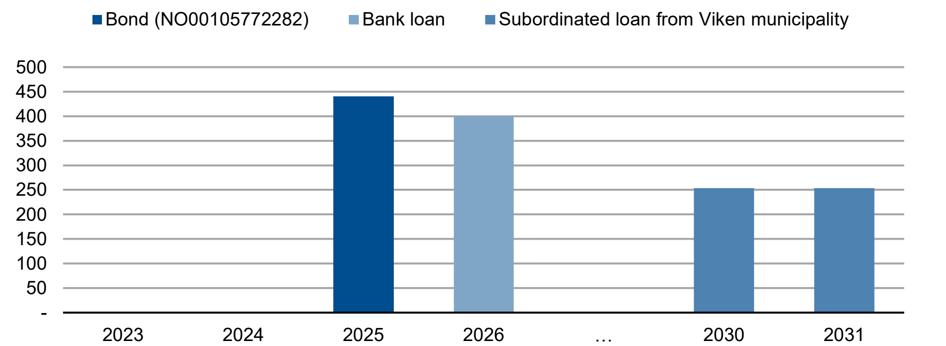
Source: Vardar, Scope (estimates)

Adequate liquidity

Liquidity is adequate, with no debt maturities in 2024. At end-2022, availability liquidity included unrestricted cash of NOK 207m and NOK 50m of undrawn committed credit lines. Liquidity is further supported by positive forecasted free operating cash flow of more than NOK 200m per annum. The next maturing debt is a NOK 440m bond due in 2025, followed by a NOK 400m bank loan with maturity in 2026. The bank loan includes a one-year extension right. We believe maturing capital market debt will likely be refinanced by new debt issuance. Additionally, we note that refinancing of the subordinated loan from Viken county municipality is not possible until the NOK 440m outstanding bond has been repaid, given a clause in the bond agreement.

Balance in NOK m	2022	2023E	2024E
Unrestricted cash (t-1)	41	207	221
Open committed credit lines (t-1)	50	50	50
Free operating cash flow (t)	567	225	206
Short-term debt (t-1)	296	0	0
Coverage	**222%**	**No ST debt**	**No ST debt**

Figure 15: Debt maturity profile excluding operating leases as of Q3 2023, NOK m



Source: Vardar, Scope

Financial covenants

We anticipate the company will be able to maintain good headroom under its financial covenants[6], which include: i) adjusted equity to be at least 150% of external interest-bearing debt, ii) cash and cash equivalents to exceed next year's interest cost, and iii) operating cash flow adjusted for next year's dividend payout to exceed next year's interest cost (t+1).

Supplementary rating drivers: +1 notch

No impact from financial policy

We assess no credit impact from financial policy. The company has a dividend policy of paying out 50% of net profit adjusted for significant non-cash items, but subject to financial robustness. Additionally, we believe the company will take financial decisions aimed at maintaining an investment grade credit rating, although it has no publicly stated targets for credit ratios or rating commitments.

Joint ownership with Drammen municipality for stakes in Å Energi

In terms of structure, we note positively the company's formal agreement with Drammen municipality to exercise joint ownership in Å Energi, which gives both of Vardar and Drammen greater influence over major decisions relating to dividend policy and core business composition.

A one-notch uplift granted for parent support

The issuer rating incorporates a one-notch uplift to the standalone credit assessment of BBB reflecting the company's GRE status and leading to an issuer rating of BBB+. We have applied the bottom-up approach using the framework outlined in Scope's Government Related Entities Methodology. Our conclusion of a one-notch uplift reflects the public sponsor's 'high' capacity and 'medium' willingness to provide financial support, if required. In addition to Vardar's importance to the policy objectives of its owners, we note that hydropower generation assets in Norway are required by law to be at least two-thirds owned by the state or municipalities. The rating uplift is 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

Short-term debt rating: S-2

The short-term debt rating of S-2 reflects the underlying BBB+/Stable issuer rating and adequate liquidity, in addition to good access to external funding from banks and debt capital markets.

Senior unsecured debt rating: BBB+

Senior unsecured debt is rated BBB+, the same level as the issuer rating.

[6] Interest cost used for the calculation of covenants ii)-iii) does not include interest incurred on the subordinated loan from Viken county municipality.

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